Report Number : ICRR12302

IEG ICR Review
Independent Evaluation Group

1. Project Data:		**Date Posted :**	01/26/2006	
PROJ ID :	P082597		**Appraisal**	**Actual**
Project Name :	Colombia Programmatic Financial Sector Loan II	**Project Costs (US$M)**	100	100
Country :	Colombia	**Loan/Credit (US$M)**	100	100
Sector(s):	Banking; Housing finance and real estate markets; Non-compulsory pensions insurance and contractual savings; Capital markets	**Cofinancing (US$M)**		
L/C Number :	L7258			
		Board Approval (FY)		5
Partners involved :		**Closing Date**	03/31/2005	03/31/2005
Evaluator :	**Panel Reviewer :**	**Division Manager :**	**Division :**	
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2. Project Objectives and Components

a. Objectives

1. Bank Regulation and Resolution: A. Implement reformed financial system law to ensure sustainability of the financial system by upgrading banking regulatory, supervisory, and institutional framework . B. Implement reformed financial system law for improving effectiveness of banking resolution procedures by upgrading bank resolution and deposit insurance operational framework .
2. Housing Finance: Strengthen housing finance sector and expand mortgage market by upgrading regulatory/operational framework of the mortgage market and improving access to credit .
3. Non-bank Financial Institutions: Strengthen regulatory framework and financial soundness of insurance, trusts, and pension industries by upgrading regulatory framework for risk management and capital adequacy of non -bank financial service institutions.
4. Capital Markets: Modernize legislative framework for the securities market by upgrading regulatory framework for governance, transparency, operations, and liquidity of the securities market .
5. Government Debt and Money Markets: Upgrade policy and operational framework for government securities market by implementing a Public Debt Issuance Strategy to improve functioning of the fixed income market .

b. Components (or Key Conditions in the case of Adjustment Loans):

1. Bank Regulation and Resolution; 2. Housing Finance; 3. Non-bank Financial Institutions; 4. Capital Markets; 5. Government Debt and Money Markets.

c. Comments on Project Cost, Financing, Borrower Contribution, and Dates

PFSAL II was the second of two one-tranche adjustment operations; the first was of US$ 150 million, and the second of US$100 million. (PFSAL II was originally planned to be US$ 150 million; the ICR does not provide a reason for its downsizing) PFSAL II closed on schedule on March 31, 2005.

3. Relevance of Objectives & Design :

The objectives as stated are important to the country and responsive to financial system weaknesses revealed during the banking sector crisis of the late 1990s. Addressing these weaknesses also reinforced the government's strategy of providing a stable enabling environment in which private business could flourish . The project is also a key element of the CAS approved by the Board in January, 2003.

However, project design was deficient because of : (1) the lack of a clear link between project components and "expected outcomes," (2) the limited interval for implementation of the two projects (the two single tranche operations were approved and disbursed within 18 months of each other); (3) failure to address the financial transaction tax, which decreased the incentives to financial sector deepening .

In terms of *improved governmental processes and institutional development* , the project is well-designed. The regulations, strengthened procedures, and additional capacity are substantially relevant to the problems the project addresses. However, the Program Document (PD) presents "*Expected Outcomes from the Program*" (Annex 1--Policy Matrix) that, in effect, are the expected outcomes of this program, since PFSAL II is the last in this Program .

As such, many of these are unrealistic in terms of what could reasonably be achieved in 18 months. If these were actually medium-term goals, then the PD should have specified intermediate milestones or outcomes that could signal that appropriate progress was being made.

Also, both projects--comprising the entire program--were completed within 18 months. It was unrealistic to design a project, PFSAL II, following so soon after PFSAL I when the objectives involved fundamental institutional and operational strengthening and capacity building. Due to the lack of realism in the expected project outcomes and the time allowed for realization, relevance is assessed as *modest*.

4. Achievement of Objectives (Efficacy) :

Macroeconomic Performance: Colombia's overall macroeconomic performance improved in the period immediately before and during PFSAL II. Real GDP growth averaged 4.0% per annum from 2003-2005, while it had averaged 2.1% annually from 2000 to 2002. Inflation fell monotonically from 1998 to 2005, and averaged 5.7% from 2003-2005, while it had been 7.8% from 2000 to 2002. The country's debt situation improved; from a peak of 52.3% of GDP in 2002, total external debt declined to 35.9% in 2005. Similarly, total public debt declined from 60.2% of GDP in 2002 to 50.4% in 2005. (A substantial factor in reducing the debt burden was the appreciation of the peso against the US dollar) However, the current account worsened in 2005 with a deficit of 2.8% compared to an average deficit of 1.4% during the previous 4 years. And the combined public sector deficit improved but remained problematic; after falling from 5.5% in 1999 to 3.7% in 2002 and then to 1.3% in 2004, the deficit rose in 2005 to 2.5%. The continued public sector deficit will require the government to issue additional T-bills, which may "crowd out" private sector borrowing. These T-bills may increasingly replace private sector loans on bank balance sheets, changing the nature of the risks confronting the banking sector (Joint Bank-Fund FSAP, 2005).

1. Bank Regulation and Resolution: A. Implement reformed financial system law to ensure sustainability of the financial system by upgrading banking regulatory, supervisory, and institutional framework. *Modest achievement*: Many planned enhancements to the bank regulatory process --especially related to conglomerates--have not yet been fully operationalized: draft rules for capital exposure arising from financial groups, and pending legal modifications to the Commercial Code defining a financial conglomerate; consequently, consolidated supervision remains weak. Finally, new guidelines for the application of disciplinary standards have not yet been operationalized. However, other aspects of the regulatory regime (not related to conglomerates) have been strengthened: risk-based supervision of banks has been introduced, management of intervened banks has been improved (which in turn reduced fiscal liabilities), and a disciplinary unit has been created in the legal department of the Superintendency of Banks (SB).

Many indicators of banking system health have improved, e.g., return on equity, capital adequacy ratio (which stayed constant as market risk regulations were tightened), and the proportion of past due loans). This can be attributed to improved regulation, in part, but also to the favorable macroeconomic situation. However, the efficacy of the more robust regulatory regime (when it is completely implemented) will not be fully evident until it is tested by adverse circumstances and can "avoid (or appropriately manage) the occurrence of any financial crisis in the future ...." (PFSAL II PD, para. 18).

B. Implement reformed financial system law for improving effectiveness of banking resolution procedures by upgrading bank resolution and deposit insurance operational framework. *Substantial achievement*: The Ministry of Finance (MOF) and SB have issued regulatory norms that facilitate more effective use of asset securitization; deposit insurance premiums are now based on individual banks' risk profiles. Two of the 3 banks identified for divestiture or liquidation were sold, with some of the assets of the third bank transferred to a new entity.

2. Housing Finance: Strengthen housing finance sector and expand mortgage market by upgrading regulatory/operational framework of the mortgage market and improving access to credit. *Modest achievement*: Although the quality of mortgage lending improved (fewer past due mortgages), the origination of new mortgages was limited; insufficient evidence is presented of increased home ownership, and there was a relatively small increase in the access to housing credit for the underserved --a major emphasis of the project.

3. Non-bank Financial Institutions: Strengthen regulatory framework and financial soundness of insurance, trusts, and pension industries by upgrading regulatory framework for risk management and capital adequacy of non-bank financial service institutions. *Substantial achievement*: The SB and Securities Superintendency (SV) issued uniform regulations for insurance, trust, and pension firms to allow firms to report the market risk of investments. SB also issued new rules raising the proportion of foreign securities permitted and limiting investment in related companies. The solvency of the insurance industry has improved, however, the industry has shown only a marginal increase in terms of its capitalization and level of activity. Also, insufficient information is provided on the extent to which these new regulations are enforced.

4. Capital Markets: Modernize legislative framework for the securities market by upgrading regulatory framework for governance, transparency, operations, and liquidity of the securities market. *Substantial achievement*: Prudential capital requirements for various collective investment schemes were harmonized, and mutual fund public "disclosure sheets" were standardized. A new Securities Law (Law 964/2005) was approved that establishes a framework for capital markets: norms for corporate governance; standardized requirements for the issuance of securities; entry qualifications for securities industry professionals. The Law also provides for definition of supervisory powers; custody, clearance, and settlement regulations; regulation of intermediaries; and shareholder protection. However,

the issuance of new securities declined, rather than increased as the PD presumed. And there is insufficient evidence that the realization of presumed market efficiencies "[improved] domestic investment, business productivity, and enterprise growth" (PD, Annex 1).

5. Government Debt and Money Markets: Upgrade policy and operational framework for government securities market by implementing a Public Debt Issuance Strategy to improve functioning of the fixed income market.

Substantial achievement: The GOC instituted an improved institutional framework and strategy for managing public debt, establishing an Internal Committee for Public Debt Policy comprised of senior MOF and Central Bank officials. The GOC also established a regular weekly T-bill auction system that issued progressively greater values of T-bills, rising from 5 billion pesos per week in January, 2003, to 80 billion pesos per week by mid-2004, and subsequently rising to 100-120 billion pesos per week. And the flatter yield curve can be expected to provide a price benchmark for private bond issuers.

5. Efficiency :

N/A on an adjustment operation.

6. M&E Design, Implementation, & Utilization:

The M&E design was poor. The PD did not include explicit monitoring indicators. As noted above in section 3, many of the "Expected Program Outcomes" cited in the PD policy matrix were not realistic for a project such as PFSAL II, with 18 months allotted for program implementation overall. Project monitoring seems to have been based on fulfillment of project conditions--mainly those dealing with establishment or implementation of a stronger regulatory framework and more effective government procedures.

7. Other (Safeguards, Fiduciary, Unintended Impacts--Positive & Negative):

8. Ratings:	ICR	ICR Review	Reason for Disagreement /Comments
Outcome:	Satisfactory	Moderately Satisfactory	Project relevance was modest (sec. 3), and some expected regulatory enhancements have not yet been achieved.
Institutional Dev .:	Substantial	Substantial	
Sustainability:	Likely	Likely	
Bank Performance:	Satisfactory	Satisfactory	
Borrower Perf .:	Highly Satisfactory	Satisfactory	There is insufficient evidence to support a rating of highly satisfactory. While the government made progress in strengthening financial sector regulation, some measures envisioned under the project to enhance the bank regulatory process have not yet been fully operationalized.
Quality of ICR:		Exemplary	

NOTES:
- When insufficient information is provided by the Bank for IEG to arrive at a clear rating, IEG will downgrade the relevant ratings as warranted beginning July 1, 2006.
- ICR rating values flagged with ' * ' don't comply with OP/BP 13.55, but are listed for completeness.

9. Lessons:

- **A program that is attempting to achieve fundamental institutional and operational strengthening needs to be allotted time commensurate with the depth of the reforms being undertaken.**
- **The improving performance of the Colombian economy during the project facilitated achievement of its objectives.** This once again demonstrates the sensitivity of financial sector operations to the macroeconomic environment.

10. Assessment Recommended? ● Yes ○ No

Why? A PPAR of financial sector projects, including this project, is currently underway.

11. Comments on Quality of ICR:

The ICR is excellent, and provides outstanding information on performance in the various sub-areas of the financial sector. The candid evaluation clearly delineates the achievements of PFSAL II and those of the overall program.

The ICR would have been even better if it had addressed issues such as the unrealistic "expected outcomes" and the brevity of the program compared with these expectations .