ICR Review
Operations Evaluation Department

Report Number : ICRR11449

1. Project Data:		Date Posted :	04/28/2003	
PROJ ID:	P063643		Appraisal	Actual
Project Name :	Co-fsal	Project Costs (US$M)		
Country:	Colombia	Loan/Credit (US$M)	EUR 482,300,000	EUR 310,208,710
Sector(s):	Board: FSP - Banking (47%), General finance sector (37%), Housing finance and real estate markets (6%), General agriculture fishing and forestry sector (5%), Central government administration (5%)	Cofinancing (US$M)	500	500
L/C Number:	L7000; LB118			
		Board Approval (FY)		00
Partners involved :		Closing Date	12/31/2001	12/31/2001

Prepared by :	Reviewed by :	Group Manager :	Group:	
Jorge Garcia-Garcia	Madhur Gautam	Kyle Peters	OEDCR	

2. Project Objectives and Components

a. Objectives

1. Carry out the Government program spelled out in its Policy Letter;
2. Change financial sector legislation and regulations to strengthen bank supervision and deposit insurance, and to promote timely, fair and efficient resolution of insolvent banks;
3. Strengthen the institutional capacity of the Superintendency of Banks and FOGAFIN, the entity responsible for deposit insurance and bank resolution;
4. Restructure, recapitalize, privatize and, if necessary, liquidate state owned and "officialized" banks under public sector management;
5. Implement special measures to address the immediate impact on the financial system stemming from economic and other emergencies;
6. To maintain Colombia's access to the global financial markets on terms and conditions that would permit a sustainable fiscal stance. This is an implicit objective, added after the loan was partially converted to a Policy Backed Guarantee.

b. Components

1. *Macroeconomic management*. Maintaining a satisfactory macroeconomic framework as established by the Government in its development program with the goals of achieving stabilization, reductions in the fiscal deficit (from 6% of GDP in 1999 to 3.5% of GDP in 2000, 2.5% of GDP in 2001, and 1.5% of GDP in 2002), in inflation (from 12% in 1999 to 6% in 2002), in ex-post real interest rates, and in the current account to below 3% of GDP.
2. *Legal and regulatory framework*. To strengthen the legal, regulatory and institutional framework the Government committed to: (a) carry out required changes in financial sector legislation to facilitate dealing with capital adequacy and prudential rules, use market based bank resolution devices, and reform the deposit insurance system; and (b) take agreed upon actions to strengthen the Banking Superintendency and FOGAFIN .
3. *Resolution and restructuring of Government banks*. (a) Bring to the point of sale, or initiate the liquidation, of Banco del Estado, Banco Central Hipotecario, Banco Cafetero -BANCAFE-, Corporacion Colombiana de Ahorro y Vivienda-GRANAHORRAR, and Banco UCONAL; (b) Implement the plan for the restructuring, privatization, recapitalization or liquidation of the financial institutions referred in (a), in accordance with the terms stated in Attachment 2 of the Government's Policy Letter.
4. *Cooperatives*. Implement plan agreed in Policy Letter for resolution of financial cooperatives, and Banking Superintendency to adopt satisfactory principles, strategy and action plan to license and supervise cooperatives .
5. *Housing Finance System*. (a) Implement relief program for housing mortgage debtors; (b) Put into effect rules to ensure that the real cost of new housing loans is transparent, and that indexing mechanisms for such loans are designed to ensure sustainable payment capacity by borrowers .

6. *FOGAFIN*. (a) Separate the funding for FOGAFIN's special activities from the funding for FOGAFIN's mainstream financial institution resolution and banking deposit insurance activities; (b) make available to FOGAFIN in Colombian pesos the equivalent of 200 million dollars for purposes of FOGAFIN's financial institution resolution and or banking deposit insurance activities; (c) FOGAFIN's credit programs for asset management and securitization companies, and FOGAFIN's programs to re-capitalize financial institutions are being implemented in a manner consistent with the objectives of the program.
7. *Study*. Complete study on options to rationalize and increase the efficiency of second -tier financial institutions.

c. Comments on Project Cost, Financing and Dates

Before the release of the second tranche, the Colombian Government requested and the Bank agreed to use the second tranche to support a policy-based rolling reinstatable guarantee of up to Euro 238.74 million to guarantee up to US$1 billion of long-term Government bonds placed internationally. The guarantee had two payments rolled over if Colombia did not default, and made the bond "investment grade".

3. Achievement of Relevant Objectives:

1. The Government issued the regulations required to strengthen bank supervision and deposit insurance, putting into effect a system of performance indicators for financial intermediaries that permit the Superintendency of Banks to monitor solvency, financial performance and other problems that financial institutions face .
2. The Government carried out the plan to resolve and restructure Government banks .
3. The Superintendency of Banks screened all 54 cooperatives that could be classified as financial cooperatives and issued new rules and regulations to license and supervise cooperatives .
4. The authorities changed the indexation system for housing finance loans, tying the indexation to a reliable inflation index certified by the Central Bank. The new system of indexation makes the full cost of housing loans fully transparent.
5. The Government: (a) issued a decree requiring FOGAFIN to separate the accounts of problem bank resolution, deposit and other insurance companies from emergency relief activities it undertakes on its behalf; (b) gave FOGAFIN about US$300 million to fund regular bank resolution activities; and (c) through FOGAFIN, implemented programs for asset management and securitization companies
6. The study on options to rationalize and increase the efficiency of second tier financial institutions was completed .

4. Significant Outcomes/Impacts:

1. Caja Agraria was closed. Banco Central Hipotecario, Banco del Estado and Banco UCONAL ceased all their deposit and lending operations, and their assets and liabilities were transferred to other financial institutions . FOGAFIN's Board approved a resolution plan for Granahorrar that calls for the gradual transfer of its assets and liabilities to a special fiduciary trust.
2. Takeovers of financial institutions by FOGAFIN have declined, from 13 during 1999 to five in 2000 and one in 2001, because financial institutions are healthier and there are fewer left.
3. After a cumulative loss of 88 percent of capital in 1998-2000, profitability has returned to the banking system. Return on equity in 2002 (first half) increased to 6.5%, up from 1.1% in 2001.
4. In the banking system, problem loans as a share of capital declined from 82 percent in 1999 to 56 percent in 2001 and 52 percent in the first half of 2002, and the ratio of operating expenses to net income fell from 81 percent in 1999 to 66 percent in 2002.
4. Inflation fell to 7 percent in 2002 (target was 6 percent) and the current account deficit fell to about 1 percent of GDP over 2000-2002 (target was 3 percent.)
5. The conversion of the second tranche into guarantee helped the Government to re -enter the US commercial financial market to borrow.

5. Significant Shortcomings (including non-compliance with safeguard policies):

1. The Government reduced the fiscal deficit and inflation, but the situation of the consolidated public sector deteriorated over 2000-2002. Financed by domestic and external borrowing, the net public sector debt increased from about 44 percent of GDP in 1999 to about 57 percent of GDP in 2002.
2. The consolidated nonfinancial public sector deficit reached 3.5 percent of GDP in 2001 and 4.4 percent of GDP in 2002, exceeding the levels agreed to in the Government's Policy Letter (2.5 percent of GDP in 2001 and 1.5 percent of GDP in 2002); because the Bank guarantee allowed the Government to borrow in international markets, it helped to maintain the fiscal deficit at levels that exceeded those agreed to in the Policy Letter .
3. The Government suspended the sale of Banco Cafetero because it considered its proposed valuation as too low .
4. The rolling reinstatable guarantee did not reduce the interest rate on the loan commensurately . While the bond spread over US Treasuries (a commonly used benchmark) was lower than unguaranteed comparable Colombian issues (trading in the secondary market), the difference was smaller than the security that the guarantee provided (SecM2003-0046, February 3, 2003). Some in the Bank warned (based on the experience with earlier guarantees like Argentina and EGAT) that this would be the case before the Bank approved the second tranche conversion, and the bond was issued. While advocates of the guarantee claim broader benefits of issuing the bond, they do not contest the pricing issue.

6. Ratings:	ICR	OED Review	Reason for Disagreement /Comments

Outcome:	Highly Satisfactory	Moderately Satisfactory	The loan has a satisfactory outcome in the financial sector component, but a moderately unsatisfactory macroeconomic outcome because of its lax fiscal policy and the build up of government debt. The outcome of the loan is therefore moderately satisfactory.
Institutional Dev .:	High	Modest	Loan helped to support the Government's rescue of some financial institutions under stress, but it should be questioned whether the policies and institutions can avert a similar crisis.
Sustainability :	Likely	Non-evaluable	The large fiscal deficits and the growing public sector debt make it difficult to assess whether Colombia's economic situation will continue to improve.
Bank Performance :	Satisfactory	Satisfactory	
Borrower Perf .:	Highly Satisfactory	Satisfactory	The Government carried out the agreed reforms for the financial sector, but did not meet the fiscal targets agreed in the policy letter.
Quality of ICR :		Satisfactory	

NOTE: ICR rating values flagged with ' * ' don't comply with OP/BP 13.55, but are listed for completeness.

7. Lessons of Broad Applicability:

1. Macroeconomic stability (and hence sound fiscal policy) is necessary for a healthy financial system. Banking rescues add to the fiscal burden.
2. International capital market inefficiencies can sometimes be exploited to a country's advantage (e.g., World Bank interest swaps) and Bank guarantees could allow this to happen, but the terms must be carefully scrutinized because, as in this case, the inefficiencies were not in Colombia's favor.

8. Assessment Recommended? ● Yes ○ No

Why? The Bank needs to know better how financial sector reform improved macroeconomic outcomes, and why the policy-based guarantees were instituted. OED should evaluate the entire Bank guarantee program.

9. Comments on Quality of ICR:

The ICR provides useful information about most of the financial aspects of the loan but could pay more attention to the fiscal problems plaguing the economy, the build up of debt and whether the policy-based guarantee was advantageous. The ICR should have discussed the macroeconomic issues better, because the FSAL, a fiscal support loan, represented more than half of the Bank's lending and disbursements to Colombia in FY 2000. The ICR should have provided information about cost and access (without guarantee, with guarantee, and with rolling reinstatable guarantee), especially because of the controversy in the Bank on whether the second tranche of the loan should be converted into a guarantee.

The ICR could have been concise and avoided repetition. It also could have presented a table with numbers summarizing the main achievements of the loan in terms of its financial impact in the financial sector. The ICR's structure and its arbitrary grouping of topics makes it difficult to follow. The ICR could have presented a table with the legal covenants, pointing out how the Government fulfilled them (Laws, decrees, resolutions, administrative letters.

The information on disbursements and cancellations does not match that from the loans department.