Board of Executive Directors

For consideration

On or after 7 June 2017

PR-4480
23 May 2017
Original: Spanish
Public
Simultaneous Disclosure

To:	The Executive Directors
From:	The Secretary
Subject:	Colombia. Proposal for a loan for the “Financial System Reform Support Program II”

Basic Information:

Loan type .... Programmatic Policy-Based Loan (PBP)
Borrower .... Republic of Colombia
Amount .... up to US$400,000,000
Source ....Ordinary Capital
Amount .... up to US$50,000,000
Source ....China Co-financing Fund for Latin America and the Caribbean

Inquiries to: Daniel Fonseca (extension 3451) or Agustina Calatayud (extension 4828)

Remarks: As established in document GN-1838-1, “Criteria and norms for Board and Management relations”, dated 1 July 1994, policy-lending operations are considered by the Board of Executive Directors by Standard Procedure.

This operation is the second loan in a programmatic series of two consecutive single-tranche operations, technically related to one another but independently financed as programmatic policy based loans, in accordance with document CS-3633-1, “Policy-based Loans: Guidelines for Preparation and Implementation. New version”.

Reference: GN-1838-1(7/94), DR-398-17(1/15), CS-3633-1(6/14), GN-2200-13(4/05), GN-2686-4(1/13), DE-246/12, PR-4319(9/15), DE-92/15, CS-4170(5/17)

PUBLIC
SIMULTANEOUS DISCLOSURE

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

COLOMBIA

FINANCIAL SYSTEM REFORM SUPPORT PROGRAM II

(CO-L1214)

LOAN PROPOSAL

This document was prepared by the project team consisting of: Daniel Fonseca (IFD/CMF), Project Team Leader; Agustina Calatayud, Olver Bernal, Fernando De Olloqui, Gabriela Andrade, Alejandro Támola, María Cabrera, César Tamayo, Gloria Lugo and Annabella Gaggero (IFD/CMF); Álvaro Concha (CMF/CCO); Adriana Zorro (CAN/CCO); Miguel Angel Orellana (FMP/CCO); and Mónica Lugo (LEG/SGO).

CONTENTS

ANNEXES	
Annex I	Development Effectiveness Matrix (DEM) – Summary
Annex II	Policy Matrix

ELECTRONIC LINKS
REQUIRED 1. Policy letter 2. Means of verification matrix 3. Results matrix OPTIONAL 1. Monitoring and evaluation plan 2. Economic analysis 3. Support to SMEs and Financial Access/Supervision Sector Framework Document 4. Comparative policy matrix 5. IDB Country Strategy with Colombia 2015-2018 6. Statement by the Hon. Mauricio Cárdenas, Governor of the Fund and the Bank for Colombia; International Monetary Fund (IMF). Colombia (2016) 7. Colombia: 2016 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Colombia; Press Release; and Statement by the Executive Director for Colombia. IMF. Colombia (2016) 8. Colombia: Arrangement Under the Flexible Credit Line and Cancellation of Current Arrangement – Press Release; and Staff Report; IMF. Colombia (2016) 9. Colombia: Selected Issues. IMF. Colombia, (2016) 10. Financial Stability Report - March 2016. Banco de la República. Colombia, (2016) 11. Financial Inclusion, Growth and Inequality: A Model Application to Colombia. IMF (2014) Working Paper. 12. Economic Surveys. Organization for Economic Cooperation and Development. OECD (2015) 13. Law 1735 of 21 October 2014 mandating measures to promote access to transactional financial services and other provisions 14. Progress and goals of the Colombian economy. Ministry of Finance (2014) 15. Financing for Peace, Equity, and Education 2015-2018. Ministry of Finance (2014) 16. Strategy for Financial Inclusion. Ministry of Finance (2014)

ABBREVIATIONS

DNP	Departamento Nacional de Planeación [National Planning Department]
FDN	Financiera de Desarrollo Nacional
FOGAFIN	Fondo de Garantías de Instituciones Financieras [Deposit Insurance Fund for Financial Institutions]
IMF	International Monetary Fund
MHCP	Ministry of Finance and Public Credit
MILA	Mercado Integrado Latinoamericano [Latin American Integrated Market]
MSMEs	Micro, small, and medium-sized enterprises
OECD	Organization for Economic Cooperation and Development
PBP	Programmatic policy-based loan
PND	Plan Nacional de Desarrollo [National Development Plan]
SEPDE	Sociedad especial de pagos y depósitos electrónicos [specialized electronic payment and deposit company]
SMEs	Small and medium-sized enterprises
WEF	World Economic Forum

PROJECT SUMMARY

COLOMBIA
FINANCIAL SYSTEM REFORM SUPPORT PROGRAM II
(CO-L1214)

<table>
<tr><th colspan="5">Financial Terms and Conditions</th></tr>
<tr><td colspan="3" rowspan="2">Borrower: Republic of Colombia</td><th colspan="2">Flexible Financing Facility[(a)]</th></tr>
<tr><td>Amortization period:</td><td>20 years</td></tr>
<tr><td colspan="3"></td><td>Original WAL:</td><td>12.75 years</td></tr>
<tr><td colspan="3" rowspan="2">Executing agency: Ministry of Finance and Public Credit (MHCP)</td><td>Disbursement period:</td><td>1 year</td></tr>
<tr><td>Grace period:</td><td>5.5 years</td></tr>
<tr><th>Source</th><th>Amount (US$)</th><th>%</th><td>Inspection and supervision fee:</td><td>[(b)]</td></tr>
<tr><td>IDB (OC):</td><td>400 million</td><td>89%</td><td>Interest rate:</td><td>LIBOR-based</td></tr>
<tr><td rowspan="2">China Cofinancing Fund for Latin America and the Caribbean:[(c)]</td><td rowspan="2">50 million</td><td rowspan="2">11%</td><td>Credit fee:</td><td>[(b)]</td></tr>
<tr><td rowspan="2">Currency:</td><td rowspan="2">U.S. dollars from Ordinary Capital resources and the China Cofinancing Fund</td></tr>
<tr><td>Total:</td><td>450 million</td><td>100%</td></tr>
</table>

<table>
<tr><th colspan="7">Project at a Glance</th></tr>
<tr><td colspan="7">Project objective/description:
The objective of the programmatic series and of this operation is to increase the financial system’s contribution to Colombia’s growth by: (i) increasing financing for productive development; (ii) improving regulation and supervision of the financial system to support the development of the capital markets and financial transparency; and (iii) improving financial inclusion for the unbanked population and for micro, small, and medium-sized enterprises (MSMEs).
This is the second of two consecutive operations that are technically interconnected but financed independently under the programmatic policy-based loan (PBP) modality.</td></tr>
<tr><td colspan="7">Special contractual conditions precedent to the sole disbursement of the loan proceeds:
The disbursement of the Bank loan proceeds will be subject to the borrower’s fulfillment, to the Bank’s satisfaction, of the policy reform commitments described in the program components and detailed in the Policy Matrix (see Annex II), and fulfillment of the other conditions established in the loan contract (see paragraph 3.2).</td></tr>
<tr><td colspan="7">Exceptions to Bank policies: None.</td></tr>
<tr><th colspan="7">Strategic Alignment</th></tr>
<tr><td>Challenges:[(d)]</td><td>SI</td><td>☑</td><td>PI</td><td>☑</td><td>EI</td><td>☑</td></tr>
<tr><td>Crosscutting themes:[(e)]</td><td>GD</td><td>☐</td><td>CC</td><td>☐</td><td>IC</td><td>☑</td></tr>
</table>

(a) Under the Flexible Financing Facility (document FN-655-1), the borrower has the option of requesting changes to the amortization schedule, as well as currency and interest rate conversions. The Bank will take operational and risk management considerations into account when reviewing such requests.

(b) The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank’s lending charges, in accordance with applicable policies.

(c) These cofinancing resources will be provided by the China Cofinancing Fund for Latin America and the Caribbean. The terms and conditions of this segment of the financing will be the same as for the financing from the Bank’s Ordinary Capital resources, in accordance with document GN-2686-4.

(d) SI (Social Inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

(e) GD (Gender Equality and Diversity); CC (Climate Change and Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

I. PROJECT DESCRIPTION AND RESULTS MONITORING

A. Background, problem to be addressed, and rationale

1.1 This project is the second in a series of two programmatic policy-based loans (PBPs). The series began in 2015 with operation 3554/OC-CO, and was agreed upon with the Government of Colombia to support a set of structural measures aimed at improving the financial system's contribution to the country's growth.

1.2 Specifically, this operation supports policy reforms with objectives similar to those set out in programmatic loan 3554/OC-CO, approved in 2015, which established the program's principal legal and institutional reforms. That loan was disbursed during the same year, once the conditions precedent had been fulfilled. This second program builds on the policy reforms that have made significant progress thus far, including: (i) a 4.2% increase in lending to the private sector between 2015 and 2016, reaching a level of 48% of the country's GDP; (ii) progress in productive development, particularly through the financial close of public-private partnership transportation projects through Financiera de Desarrollo Nacional (FDN); (iii) improving regulations aimed at enhancing financial transparency and consumer protection, consistent with Colombia's objective of joining the Organization for Economic Cooperation and Development (OECD); (iv) the five percentage point increase between 2015 and 2016 in the number of people who have access to financial instruments, reaching 77.1% of the population in 2016; and (v) the first steps toward incorporating a new specialized electronic payment and deposit company, known by its Spanish-language acronym SEPDE, to be finalized by end-2017, in order to deepen financial inclusion.

1.3 **Macroeconomic context.** A policy program based on containment of inflation, gradual adjustment of public finances, and institution-strengthening has enabled Colombia to build the economy's resilience to lower oil prices, which have been declining since mid-2014.[1] Because of this, the country was able make a smooth landing when faced with shocks to the terms of trade. The GDP rose 3.1% in 2015, with 2% growth in 2016. The economy is projected to start recovering in 2017, growing 2.5% annual in 2017. Annual inflation is being contained, coming down from a peak of 9% in July 2016 to 5.8% in December 2016. The fiscal deficit is expected to gradually decline from 3.9% of GDP in 2016 to 2.7% in 2018. External accounts are undergoing an adjustment, where the current account deficit fell from 6.6% of GDP in the third quarter of 2015 to 4.7% in the third quarter of 2016. On the social front, the poverty rate continued to drop from 24.6% in 2014 to 24.1% in 2015. Inequality was reduced to 52.2 points (Gini index) in 2015, after remaining at 54 points since 2012. The reform process for accession to the OECD is proceeding in accordance with the established terms. The new peace accord between the Colombia government and the Revolutionary Armed Forces of Colombia (FARC) was approved by Congress in November 2016, which entails significant opportunities for increasing productivity and financial inclusion. In this context, recently published studies[2] all agree that, in order to achieve inclusive, sustained growth over time, the country will have to address a number of

---

1 International Monetary Fund (IMF), *Article IV Consultation – Staff Report*, April 2016.

2 See for example: Colombia CDC 2015-2018. IMF, op. cit.; IMF, *Arrangement under the Flexible Credit Line and Cancellation of Current Arrangement – Staff Report*, June 2016; OECD, *Colombia-Economic Forecast,* 2016.

challenges, including: (i) moving toward an economy with greater complexity and value-added; (ii) strengthening weak points in the area of financial sector supervision; (iii) improving financial inclusion;[3] and (iv) closing the infrastructure gap without compromising fiscal stability.

1.4 **Economic and productive structure.** The country's most important economic sectors are: the financial sector (19.7% of GDP); commerce, hotels, and restaurants (12%); industry and manufacturing (11.2%); and transportation and communications (7.3%).[4] Micro, small, and medium-sized enterprises (MSMEs) are important in the economic structure, accounting for 95% of enterprises, 80% of private employment, and 35% of GDP. Despite growth over the past 20 years, the country's economy has not undergone positive structural change, in terms of moving toward more productive, value-added sectors. Colombia has significant gaps in productivity compared with middle- and high-income countries. Between 1990 and 2011, there was near-zero growth in productivity in the economy, while countries such as Chile and Peru experienced growth of 2% and 4%, respectively. The productivity gap primarily affects MSMEs, whose productivity is 45% that of similar-sized North American enterprises.[5] Nearly 80% of the products in which Colombia possesses a comparative advantage are in the primary sector and have low comparative economic complexity (since their production requires low levels of technological capacity and human capital), so they make a limited contribution to economic growth.[6]

1.5 **Financial system.** The financial system plays a fundamental role in economic growth.[7] An efficient financial system makes it possible to: (i) channel resources to more productive actors and projects, thus stimulating growth; (ii) convert maturities, redirecting short-term savings toward long-term investments and allocating resources to productive investments, e.g. in infrastructure; (iii) smooth household and business consumption over time by reducing liquidity constraints and lessening the adverse impact of shocks on well-being; and (iv) cushion the impact of volatility and macroeconomic shocks.[8] The development of the financial system in Colombia has significantly improved in recent years. In 2012, the World Economic Forum (WEF) ranked Colombia 46th, behind Chile (29th), Brazil (32nd), and Peru (41st). In 2016, Colombia had moved up 21 places and ranked 25th in the world and third in the region, behind Panama (15th) and Chile (21st).

---

[3] Financial inclusion is defined as access to and use of formal, quality financial services by households and enterprises, within a framework of financial stability for both the system and the users. Financial services include payments and transfers, credit, savings, and insurance.

[4] Departamento Administrativo Nacional de Estadísticas [National Administrative Department of Statistics], GDP, 2015.

[5] Ministry of Industry, Trade, and Tourism*, Reporte de Micro, Pequeñas y Medianas Empresas (MIPYME)* [Report on Micro, Small, and Medium-sized Enterprises (MSMEs)], 2011.

[6] Output per worker is understood as a measurement of productivity. For a detailed analysis of the relationship between value-added, economic complexity, and growth, see: Hausmann et al., *The Atlas of Economic Complexity,* 2014.

[7] Beck, T.; Levine, R. y Loayza, N., "Finance and the Sources of Growth," *Journal of Financial Economics* 58(12), 261-300, 2000.

[8] IDB, Support to SMEs and Financial Access/Supervision Sector Framework Document (document GN-2768-3), 2014.

1.6 **Reform priorities.** In order to improve the development of the financial system and in accordance with various assessments,[9] three reform areas were identified in the first operation: (i) increase financing for productive development, in order to move toward a more productive and complex economy and close the gap in infrastructure investment so as to bring about sustained growth for the country's economy; (ii) lock in gains in financial system regulation and supervision, promoting greater transparency and developing capital markets, in order to mobilize resources and diversify financing mechanisms to address productive investment needs, without compromising fiscal stability; and (iii) improve financial inclusion, in order to alleviate liquidity constraints on households and enterprises, while improving their levels of consumption and investment and helping to reduce inequality and vulnerability. This operation provides continuity for measures that support the Colombian government with the identified reforms, which are fully consistent with the country's National Development Plan (PND) 2014-2018. The following section describes the progress made in the first operation, as well as the reforms envisaged by the second operation for each of these reform areas.

1. Financing for productive development in Colombia

1.7 **Access to finance, productivity, and growth.** Access to finance is a critical factor for increasing an economy's productivity and complexity and stimulating economic growth. Greater access to finance facilitates: (i) long-term investment, allowing for the development of projects in strategic sectors and the improvement of productive infrastructure; (ii) adoption of productive technology and techniques, promoting innovation and research and development; (iii) access to markets and to segments of global value chains with higher value-added; and (iv) mitigation of volatility and the effects of macroeconomic shocks on the economy.[10]

1.8 **Productive financing in Colombia.** The flow of financing to Colombia's productive sector is strongly dominated by commercial banks, which account for 44% of all financial system assets (62% of GDP). Data for 2015 show a 15.5 percentage point increase in loans to the private sector compared to 2013, representing 48.8% of GDP. Indicators on the quality of the commercial bank loan portfolio remained stable, with total non-income producing loans averaging about 2.5% of the total portfolio.[11] The cost of credit fell four percentage points, from 11% in 2013 to 7% in 2015. Access to credit for small and medium-sized enterprises (SMEs) increased four percentage points, representing 45% of SMEs.[12] This factor is far from negligible when considering the vital role of financing in increasing an economy's productivity, and the dominant role of SMEs in Colombia's economy. In addition, financing for the agriculture sector increased 3.7% in the first half of 2016.[13] Lastly, Colombia made progress in closing the gap in transportation

---

[9] IMF, *Article IV Consultation – Staff Report*, April 2016. WEF, *The Global Competitiveness Report 2015-2016*, 2016.

[10] For an exhaustive analysis of the relationship between financial development and productivity, see: IDB, op. cit., 2014.

[11] Asobancaria, Evolución y desarrollos del sistema financiero colombiano y del mercado de capitales [Evolution and Developments of the Colombian Financial System and Capital Markets], June 2016.

[12] Asociación Nacional de Instituciones Financieras [National Association of Financial Institutions] (ANIF), Report on Results of the Major SME Survey, 2015.

[13] Financial Superintendency of Colombia, Statistics on active credit operations by economic sector, 2016.

infrastructure investment, which is needed to reduce logistical costs and increase the productivity of its productive sector. Fourth-generation highway concession projects alone are expected to contribute 0.39 percentage points to GDP between 2015 and 2022.[14]

1.9 The reforms implemented in the first operation sought to improve access to finance for the productive sector by strengthening guarantee systems and public institutions for financing productive development. By approving the Law on Secured Transactions, regulating the operation of the Secured Transactions Registry, and approving registration forms and fees for the Secured Transactions Registry, progress was made toward the adoption of legislation on secured transactions based on international best practices. This helped reduce the levels of collateral required of enterprises while diversifying the sources of collateral, particularly in the case of SMEs and agricultural enterprises, which have greater difficulty providing real-property guarantees as collateral for loans. Together with the creation of the Master Registry of Electronic Invoicing, these reforms helped move toward better credit information systems and better protection of creditors in terms of using or recovering guarantees in cases of nonpayment. As a result, between 2014 and 2015, the country reduced its distance to frontier score by 32 points with respect to the best positioned countries in the access to credit indicator in the *Doing Business Report.*[15]

1.10 In addition, reforms were adopted to strengthen the institutional framework for productive financing. Within this framework, public development banks play a fundamental role in promoting investment in economic sectors or in market segments in which there are multiple market failures in matching supply and demand for financing, which act as a disincentive to action by the private sector. In Colombia, these failures are particularly severe in the agriculture sector (due to risks associated with climate, marketing, and prices, as well as the concentration of risks based on activity or region, limitations in collateral and high transaction costs involved in providing small-scale loans across broad geographic areas) and in the infrastructure sector (due to the strong presence of externalities and macroeconomic, political, and other risks). Given these market failures, public development banks could help improve access to finance by offering resources for productive investments and improving conditions to incentivize and facilitate private investment (e.g., through publicly guaranteed funds and public-private partnerships). Accordingly, the reforms focused on: (i) passage of the law on financing for revitalization of the agriculture sector and issuance of circulars on the operating regulations of the Agriculture Guarantee Fund, to increase financing for this sector; and (ii) strengthening public banks as catalysts of infrastructure investment, through a reform of the FDN's bylaws, the adoption of commitments by the nation as the majority shareholder in FDN, and modification of maximum individual credit amount for FDN.

1.11 **Pending challenges.** Despite the progress made, productive financing in Colombia remains a crucial obstacle to the performance of companies in the

[14] Asobancaria, *Evolución y desarrollos del sistema financiero colombiano y del mercado de capitales* [Evolution and Developments of the Colombian Financial System and Capital Markets], June 2016.

[15] World Bank, *Doing Business Report,* 2016.

country.[16] Credit to the private sector as a percentage of GDP is still low compared to other countries of the region such as Brazil (67.9%) and Chile (111.2%), and high-income countries (150%).[17] The cost of credit continues to be higher than in other countries in the region such as Chile (1.9%) and Mexico (2.8%), and higher than the average in high-income countries (2.6%). Access to credit for small firms is still limited, since barely 41% of SMEs obtained loans, which are typically concentrated in short-term financing that does not allow them to properly develop investment projects. The implementation of a Secured Transactions Registry is an important tool that will allow SMEs to use collateral. In furtherance of this measure, the country will develop additional provisions aimed at promoting the use of this tool by financial institutions. Loans to the agriculture sector are also limited, as only 38% of producers have access to finance. Lastly, the availability of resources to finance infrastructure poses a significant challenge to the performance of enterprises, productivity, and the growth of the economy. Recent data[18] show that Colombian businesses regard inadequate infrastructure as the third biggest problem. Furthermore, according to available studies,[19] in order to accelerate the country's economic growth to 6% and increase economic productivity to 2%, the country needs to invest close to 3.3% of GDP annually in investment projects over the 2012-2020 period. To address these challenges, the second operation will continue the line of reforms established in the first operation, focusing on areas that improve the guarantee system and strengthen institutions in order to finance productive development, primarily in the agriculture and infrastructure sectors. In doing so, the country would achieve the objective of implementing valuable instruments that would expand the supply of financial system products and provide more loans, with a direct impact on the inclusive growth of SMEs and the agriculture sector, as well as on the feasibility of the infrastructure investments described in the National Development Plan.

2. Regulation and supervision of Colombia's financial system

1.12 **Regulation and supervision, development of the financial system, and growth.** Effective regulation and supervision of the financial system is essential to ensure that development of the system does not compromise its stability. It also helps prevent financial crises, whose effects undermine the confidence of agents in the financial sector, limiting growth in savings and intermediation, forcing the exit of actors from the capital markets, and restricting the availability of medium- and long-term financing. Studies that evaluate the effects of structural reforms on economic growth show that financial regulation and supervision are among the factors that have the greatest impact.[20]

1.13 **Current conditions in Colombia.** The first operation focused on strengthening the regulation and supervision of the financial system and improving financial transparency. In the first area, the progress made has been noted in international

[16] WEF, *The Global Competitiveness Report 2015-2016*.

[17] IMF, *Article IV Consultation – Staff Report*, April 2016. World Bank, *World Development Indicators,* 2015.

[18] Ibid.

[19] National Association of Financial Institutions, Infrastructure investment in Colombia, 2013.

[20] Norris, D. et al., *Reforms and Distance to Frontier,* IMF Discussion Note, 2013.

assessments,[21] which point to the positive effect of reforms on the stability of the system. Colombia has a sound financial sector, with solvency and liquidity levels that have remained high despite the deterioration of external conditions. The stress tests conducted in late 2015 showed that the banking sector would remain solvent even in the event of extreme macroeconomic conditions.[22] Supervision of the financial system has been strengthened by regulations, such as those giving the Financial Superintendency greater authority to impose higher capital and liquidity requirements on financial institutions with a higher risk profile, as well as by regulations to ensure the independence and legal protection of the supervisor. In the second area, progress has been made in making the financial system more transparent through regulations such as: (i) updated instructions applicable to supervised entities; (ii) regulations on the solvency of factoring enterprises; (iii) approval of the law on information for consumers of financial services; and (iv) convergence with the International Financial Reporting Standards (IFRS). In addition, Colombia has an assets and liabilities management system for financial institutions that serves as a benchmark in Latin America. These advances provide greater certainty and clarity for investors, and maintain the effective functioning and transparency of the financial system. International good practices on financial transparency[23] suggest that expanded and more effective supervision combined with greater availability of reliable information regarding operations and entities participating in the system are indispensable elements for improving financial risk management and reducing the likelihood of a systemic crisis and the ensuing negative impact on a country's growth. These reforms are consistent with a road map for reforms to strengthen the regulation and supervision of the financial system in the context of Colombia's accession to the OECD.[24]

1.14 In addition to the measures to improve the regulation, supervision, and transparency of the financial system, Colombia implemented regulations to stimulate the development of capital markets. International assessments point to the following as some of reasons for the low level of development of these markets in the country: (i) the cost and time involved in public offerings, issuing requirements, public disclosure rules, and registration, which affect the market participation of SMEs and one-time issuers (e.g., for infrastructure projects); (ii) the low risk tolerance of investors in light of potential volatility in market prices; and (iii) the onerous requirements for international investors wishing to participate in the market, a factor that discourages nontraditional investors from participating in projects, such as infrastructure projects, through public-private partnership mechanisms. The measures adopted to solve these problems and stimulate the development of capital markets include: (i) the simplification of documentation requirements for issuers in the Secondary Market; (ii) the decree on the issuance of hybrid securities as instruments for capitalizing credit institutions; (iii) approval of the New Country Code of Corporate Best Practices; (iv) the decree on price stabilization mechanisms; and (v) the modification of provisions on individual credit

[21] IMF, *Article IV Consultation – Staff Report*, April 2016; IMF, *Arrangement under the Flexible Credit Line and Cancellation of Current Arrangement – Staff Report*, June 2016.

[22] IMF, *Arrangement under the Flexible Credit Line and Cancellation of Current Arrangement – Staff Report*, June 2016.

[23] OECD, *Policy Framework for Effective and Efficient Financial Regulation*, 2010.

[24] See OECD, *Roadmap for the Accession of Colombia to the OECD Convention*, 2013.

limits, regimes for investment of resources from unemployment funds, mandatory pension funds, and portfolios that back the technical reserves of life insurance companies.

1.15 **Pending challenges.** The reforms envisaged in this operation continue the line of reforms established in the first operation. Their first objective is to support the development of capital markets in the country. The size of the capital market in Colombia is in fact quite small with respect to other comparable countries: in 2015, Colombia had just 73 companies listed on the stock exchange, compared to 141 in Mexico, 298 in Peru, and 312 in Chile. The volume of trades has been decreasing in recent years.[25] In particular, between 2012 and 2015, the trading volume in the equity market had fallen from US$41 million to US$12 million, whereas the traded volume in the bond market fell from US$651 million to US$303 million over the same period of time. Only the trading volume in derivatives saw a stable trend, rising slightly from US$37 million in 2012 to US$38 million in 2015. In the aggregate, during that period, the capitalization of the principal markets decreased by 50%, and went from representing 70% of GDP in 2012 to 36% in 2015.[26] In addition, the capital market is concentrated in sovereign debt, with non-sovereign issuers representing just 4% of GDP.[27] The corporate bond market is concentrated in issuers with high ratings (80% of securities are rated AAA, while the remaining 20% are rated AA+),[28] and there are no issuers with ratings of AA or lower. The reforms seek to strengthen the regulation, supervision, and transparency of the financial system, improving standards of conduct of participants with regard to consumers in the system, and strengthening the authority of the supervisory entity. These measures are expected to help the country develop the conditions necessary to promote greater use of the capital market, ensuring its proper operation through appropriate protections for users.

3. Financial inclusion in Colombia

1.16 **Financial inclusion, growth, and reducing vulnerability.** The economic literature demonstrates that greater participation by the population in the financial system, through financial inclusion, stimulates growth and reduces poverty and inequality.[29] Essentially, increased financial inclusion allows for greater resource flows for households and enterprises, and more efficient and secure management of those resources, which in turn makes it possible to better respond to adverse shocks, thus smoothing consumption, improving economic, education, and health opportunities, and increasing investment. At the same time, access to and use of electronic payments provides benefits associated with lower transaction costs for households, as reflected in lower physical and opportunity costs, thus generating

---

[25] Asobancaria, *Evolución y desarrollos del sistema financiero colombiano y del mercado de capitales* [Evolution and Developments of the Colombian Financial System and Capital Markets], June 2016.

[26] WEF, *Accelerating Capital Markets Development in Emerging Economies*, Supporting materials for roundtable discussions, 2015.

[27] World Bank, *World Development Indicators,* 2015.

[28] Ministry of Finance and Public Credit (MHCP*), Documento conceptual: Reforma normativa segundo mercado* [Concept Document: Secondary Market Regulatory Reform], 2013.

[29] See Karpowicz, I., *Financial Inclusion, Growth and Inequality: A Model Application to Colombia,* IMF Working Paper, 2014; Park, I. and Mercado, F., *Financial Inclusion, Poverty, and Income Inequality in Asia*, Asian Development Bank, Working Paper, 2015.

savings that may result in less wear and tear on assets.[30] All of this works to reduce vulnerability, inequality, and poverty in the population.

1.17 **Financial inclusion in Colombia.** In order to improve financial inclusion in the country, a series of reforms were implemented to simplify the requirements for accessing financial services and increase the supply of products and channels, and to establish an effective and coordinated institutional framework for the implementation of public policies to improve financial inclusion. These reforms included: (i) approval of the Law on Financial Inclusion, which created specialized electronic payment and deposit companies (SEPDEs) as a new channel for the distribution of financial products; (ii) creation of the small consumer loan modality; (iii) authorization of the distribution of insurance by correspondent banks; (iv) regulation of fees to access mobile channels providing mobile financial services; (v) creation of an intersectoral commission for economic and financial education; and (vi) identification of reporting requirements for evaluating financial inclusion in the insurance industry. Data for 2015 demonstrated that the coverage of the banking system in Colombia had reached all of the municipios in the country. In addition, the adult population with at least one financial product had increased ten percentage points between 2012 and 2016, reaching 77.1% of adults in 2016, with 64.5% of these products currently active or in effect.[31] Compared to 2014, the number and amount of transactions in 2015 increased by 17% and 6%, respectively. During the same period, the number of savings accounts increased by 8.7%, for a total of 60.7 million accounts, 46% of which were reported as active. In recent years, Colombia has made significant progress in measuring the financial inclusion of women in terms of supply and demand,[32] finding that gender gaps depend on the type of service or instrument. For example, supply data show that there are more women with at least one active financial product (39%) than men (35%), which differs from demand surveys, where there are in fact gender gaps. Segmentation, however, shows that it depends on the product. For example, while the number of women with savings accounts is slightly higher than men (38%), more men (59%) have current accounts than women (37%). In the case of credit, there is a five-point gender gap in the category of consumer loans and credit cards, but in the area of microloans, the gap reverses in favor of women, at 4 points. In 2015, a positive trend was observed in terms of the supply of insurance products. By the end of that year, the ratio of the value of premiums to GDP was 2.7%, increasing 17 percentage points with respect to 2014.

1.18 **Pending challenges.** Although the country has made progress in the area of financial inclusion, there are still some remaining challenges to achieving greater financial inclusion of the Colombian population. One-fourth of the adult population does not have any financial products, and half of the savings accounts are

---

[30] Jenny Aker et al., *Zap It to Me: The Short-Term Impacts of a Mobile Cash Transfer Program,* 2011.

[31] Financial Regulation Unit, *Informe semestral de avances* [Semiannual Progress Report], June 2016.

[32] The 2015 Financial Inclusion Report prepared by the Banca de las Oportunidades and the Financial Superintendency included the results of the first year of measuring supply data, finding that 25% of the portfolio could not be classified by gender due to the increasing importance of the Single Personal Identification Number (NUIP) as an identification number and the inability to segment statistics by gender. In addition, the same institutions conducted the first Study on the Demand for Financial Inclusion, which disaggregated most of the information by gender.

reported as being inactive.[33] There is a gap in access to financial services based on geographic area (26% of rural households have a bank account, compared to 34% of urban households) and gender (25% of women have an account in a formal financial institution, compared to 36% of men). In the case of enterprises, only 41% of SMEs have a bank loan or line of credit, compared to 72% of large enterprises.[34] The financial inclusion gap in Colombia can be explained by the high cost of financial transactions and the lack of financial products suited to the needs of the excluded population.[35] High transaction costs are due to stringent regulatory requirements (i.e., reserves, forced investments), taxes on financial transactions, and high operating costs, which are cash-intensive. The lack of appropriate financial products can be explained by high fixed operating costs in relation to the low unit value of the transactions, and a geographically dispersed population. Thus, alternative channels need to be developed for simplified financial products that meet the needs of consumers with low financial capacities. This operation continues the line of reforms proposed in the first program, which are aimed at implementing an integrated and coordinated strategy that includes the following improvements: (i) simplified procedures and requirements for access to financial services; and (ii) expanded alternative products and channels for access to financial services.

1.19 **The Bank's experience and lessons learned.** The program is consistent with the work the Bank has carried out in: (i) the framework of the Latin American Integrated Market (MILA) (ATN/FI-12889-RG, ATN/OC-14371-RG, and ATN/OC-13779-RG); (ii) the implementation of regulatory and supervisory standards in Latin America's microinsurance markets (ATN/SF-9621-RG); (iii) support for developing mobile banking for coffee growers (ATN/KK-10577-CO); (iv) promotion and expansion of electronic invoicing (3155/OC-CO); (v) support for preinvestment studies on regional infrastructure projects (ATN/OC-14753-CO) to be executed by FDN; (vi) the development of guidelines and road maps on government digital payments to foster financial inclusion (ATN/AA-14960-RG); (vii) development of an innovative model to facilitate the digitization of commercial payments for high-growth consumer goods companies (ATN/OC-14689-RG); (viii) support for Colombia's public-private partnerships program (3697/OC-CO); and (ix) the Perímetro Oriental de Bogotá public-private partnership (3562A/OC-CO-1; 3562A/OC-CO-2), a non-sovereign guaranteed loan approved in October 2015. The program builds on the operations to support Bancóldex (2080/OC-CO, 2193/OC-O, and 2949/OC-CO under CCLIP CO-X1007 and 2783/TC-CO), for a total of US$500 million, with financing support for more than 22,000 MSMEs. The program draws on the following lessons learned by the Bank in designing policy-based loans: (i) a proper sequencing of reforms should take into account the capacities of the institutions involved and establish a horizontal logic to progressively introduce the reforms, combining regulatory advances with improvements in technical capacities; (ii) the planned reforms should incorporate

[33] Banca de las Oportunidades and Financial Superintendency (2015), *Reporte de inclusión financiera* [Financial Inclusion Report].

[34] Access to finance for SMEs is crucial, since: (i) it allows enterprises to capitalize, invest, and innovate, (IDB, op. cit.); and (ii) SMEs are important in Colombia (see paragraph 1.4).

[35] According to the WEF, Colombia ranks 114th in cost of financial services (*The Global Competitiveness Report 2014-2015*).

the interests and capacities of the entities that are to implement them, so as to optimize their effectiveness; (iii) providing incentives linked to the fulfillment of preestablished objectives can be expected to increase the success of the reforms; and (iv) there should be effective coordination between the various bodies that participate in designing the reforms.[36] These lessons have been incorporated into the program design, to ensure that the reforms are approved, can be implemented effectively, are accepted by financial system agents, and have a logical sequence of milestones to follow over time.

1.20 **Coordination with other donors.** This operation is coordinated with and complements the technical cooperation actions of the International Monetary Fund (IMF) on financial system stability, the World Bank's technical assistance to improve the institutional capacity of the government with regard to strengthening financial regulation and supervision, capital market development, and financial inclusion, as well as the World Bank Group's support in capitalizing FDN and providing technical assistance for infrastructure investments.

4. Strategic alignment

1.21 **Strategic alignment.** The program is consistent with the Update to the Institutional Strategy (UIS) 2010-2020 (document AB-3008) and is strategically aligned with the following development challenges: (i) social inclusion and equality; (ii) productivity and innovation; and (iii) economic integration, to be achieved through measures aimed at: (i) including all segments of the population and firms in financial markets and services; (ii) facilitating access to finance for MSMEs; (iii) facilitating access to credit for segments of the population that face obstacles in this regard; (iv) developing financial instruments that contribute to a more efficient use of the factors of production; (v) providing sufficient infrastructure and reliable public services through the financing of public-private partnerships; (vi) increasing the productivity of MSMEs, by facilitating access to investment financing; and (vii) promoting integration, by facilitating access to capital markets and modernizing Colombia's regulatory system for the financial integration of the Pacific Alliance. The program is also aligned with the crosscutting area of institutional capacity and rule of law, through measures that: (i) improve the volume, quality, timeliness, and access to financial services for the population; (ii) strengthen public enterprises; and; (iii) promote the financing of public-private partnerships.

The operation is also aligned with the following strategic areas: (i) productivity of the economy; and (ii) social mobility and consolidation of the middle class, established in the Bank's country strategy with Colombia 2015-2018 (document GN-2832), by supporting the priority objectives related to: (i) financing for the private sector: increasing access to credit; (ii) agricultural development: increasing productivity and expanding the agricultural frontier; (iii) improving the quality of infrastructure and urban development and decreasing the economy's transaction costs; and (iv) increasing equitable access to quality basic services. The reform of the financial system promoted by this program was identified by the government as a priority area, since it supports: (i) the priorities established in the National

[36] See, for example, operation 3177/BL-NI, 3326/OC-DR, and Country Program Evaluation: Panama 2010-2014. Office of Evaluation and Oversight (OVE).

Development Plan for Colombia 2014-2018, which has the objective of improving access to financial services and developing capital markets; and (ii) the policy areas identified as necessary for Colombia's accession to the OECD.[37]

1.22 Lastly, the program is consistent with: (i) the Sector Strategy on Institutions for Growth and Social Welfare (document GN-2587-2), inasmuch as it increases the productivity and growth of SMEs, and provides access to financial services for the majority; and (ii) the Support to SMEs and Financial Access/Supervision Sector Framework Document (document GN-2768-3), which stresses the importance of having suitable institutional and regulatory frameworks for promoting access to finance for the productive sector, thereby increasing its productivity.

B. Objectives, components, and cost

1.23 **Objectives.** The objective of the programmatic series and of this operation is to increase the financial system's contribution to Colombia's growth by: (i) increasing financing for productive development; (ii) improving regulation and supervision of the financial system to support the development of the capital markets and financial transparency; and (iii) improving financial inclusion for the unbanked population and for micro, small, and medium-sized enterprises (MSMEs).

1.24 **Beneficiaries.** The program reforms are crosscutting in nature and are aimed at overcoming financial and regulatory constraints that impede the effective functioning of the financial system and limit its contribution to growth. The financial inclusion component will specifically target the unbanked population and MSMEs, in order to reduce their vulnerability. In light of this objective, and given the broad nature of the reforms, this program is expected to benefit the entire universe of actors in the economy. The program includes four components:

1.25 **Component I. Macroeconomic stability.** The objective of this component is to ensure a macroeconomic environment that is consistent with the program objectives established in the Policy Matrix.

1.26 **Component II. Improvements in financing for productive development and public-private partnerships.** Consistent with the areas of reform indicated for accession to the OECD, this component introduces reforms on two fronts:

a. **Strengthening the guarantee systems for productive development.** This operation envisages: (i) regulations on the enforcement of secured transactions and the establishment of valuation mechanisms; (ii) creation and regulation of the Master Registry of Electronic Invoicing; and (iii) regulations on the expansion of electronic invoicing.[38] The reforms will expand the supply of financing, particularly for MSMEs, through the use of movable assets and electronic invoices as loan collateral, with special registries that provide reliable and transparent information, which directly assigns instruments to ensure that creditors have adequate loan protections.

b. **Strengthening public institutions for financing productive development and public-private partnerships.** This operation envisages: (i) financial

[37] See OECD, op. cit.

[38] This measure complements operation 3155/OC-CO, considering the use of electronic invoices as loan collateral for financing.

closes on fourth-generation infrastructure concession contracts, including the issuance of new financing instruments to promote them; (ii) regulations for financing the revitalization of the agriculture sector; (iii) revision of credit concentration limits for the Agriculture Sector Financing Fund; and (iv) broadening the insurance policy spectrum for the agriculture sector. In terms of public-private partnerships, the measures will help reduce infrastructure investment gaps, using FDN as a financial arm to structure financing for these types of projects. In particular, FDN plays an important role by introducing new tools to mobilize financing by providers of private and foreign funds, given limitations in public infrastructure investment and the country’s need to close the gap. By strengthening the institutional framework for rural financing, the measures seek to increase the inclusive economic growth of the agriculture sector, which is a fundamental strategy in the National Development Plan 2014-2018.

1.27 **Component III. Improvements in the regulation and supervision of the financial system.** This component introduces reforms on two important fronts:

a. **Strengthening regulation and supervision to ensure a stronger, more developed financial system.** This operation envisages: (i) approval of the international investment regime; (ii) approval of exceptions to the definition of public offering of securities and tap issues; (iii) presentation to the National Congress of the draft law on the supervision of conglomerates and mechanisms for the resolution of financial institutions; (iv) revision of the provisions on the appointment and removal of the Financial Superintendent; (v) revision of the forced administrative liquidation process and payment of deposit insurance of the Fondo de Garantías de Instituciones Financieras [Deposit Insurance Fund for Financial Institutions] (FOGAFIN); (vi) review of the capital regime for stock market agents with regard to technical assets and operational risks; (vii) implementation of the integrated supervision framework based on corporate governance risk; (viii) modification of provisions on the administration of third-party portfolios; and (ix) review of the framework on providing advice in the securities market, the integration of financial markets by expanding fixed income financial instruments and derivatives, and the contracts of correspondent institutions and representative offices offering products from foreign capital markets. The reforms seek to strengthen the regulatory framework for the financial system on two fronts: (i) deepen the development of the financial system by strengthening the supervisor, the role of forced liquidation and the payment of deposit insurance, and adopting the supervision of financial conglomerates, as well as strengthening the conduct of capital market agents; and (ii) increase the protection of investors in capital markets by strengthening the conduct of third-party portfolio managers and conducting a comprehensive assessment that indicates the next generation of measures to strengthen regulation within the framework on the financial integration of the Pacific Alliance and the different actors that might be added as a result.

b. **Strengthening financial transparency.** This operation envisages: (i) the approval of provisions for price transparency in the general pension system and for customers of credit institutions; and (ii) updates to the International Financial Reporting Standards (IFRS). The proposed reforms seek to strengthen prudential guidelines for financial system participants and to disseminate accounting information and the information needed to ensure adequate protection of financial services consumers.

1.28 **Component IV. Improvements in financial inclusion.** This component introduces reforms in two essential areas:

a. **Improving the supply of products and channels for financial inclusion.** This operation envisages: (i) regulations to implement the Law on Financial Inclusion; (ii) update of the certification of current bank interest rates for small consumer loans; (iii) assessments of tax barriers to the formalization and creation of payment ecosystems to incentivize digital payments, and the creation of the simplified regime for small taxpayers ("monotributo"); (iv) assessment of financial system rules and regulations, in order to expand women's access to financial services; and (v) review of the regulatory framework for consumer protection, information, and channels for the distribution of inclusive insurance instruments. The proposed reforms will help develop financial services with simplified requirements, in order to increase the percentage of adults with at least one financial product, expand the use of such products, and lower the operating and maintenance costs associated with providing the services.

b. **Improving the institutional structure for increasing financial inclusion.** This operation envisages: (i) the creation and establishment of an Intersectoral Commission for Financial Inclusion; and (ii) the formulation of the National Strategy on Economic and Financial Education. The proposed measures will help establish a framework for effective coordination between public participants in the financial system, in order to further the country's agenda on financial inclusion and economic and financial education.

1.29 The program will be conducted according to the policy conditions described above in each of the four components. The design of this second operation included small changes to the original triggers with respect to those in the first operation of the programmatic series. First, the financing of public-private partnerships was added in the second component to demonstrate the important role the FDN currently plays in this area. Additional policy measures were added in the third component in order to improve the functioning of capital markets, strengthen the regulation and supervision of the financial system, clarify FOGAFIN's role in the event of adverse situations affecting regulated entities, including replacing a report with a draft decree on adequate assets of stock market agents. Lastly, the fourth component includes the tax reform law creating the simplified regime for small taxpayers, which is aimed at incentivizing the payment of taxes by informal enterprises and replacing a report with the strategy document on economic and financial education. By making these changes, the objectives of the programmatic series continue to be achieved. These improvements are the outcome of the maturing of the reforms implemented in the first operation. They strengthen the sustainability of those reforms and lay the appropriate groundwork for future interventions. For further details, see the Comparative Matrix and Rationale for Changes in the Second Operation.

C. Key results indicators

1.30 The key indicator for measuring the impact of the program will be GDP growth, which is expected to increase by 0.24 percentage points more than it would have increased in a scenario without reforms. Program outcomes will be measured by: (i) credit to the private sector as a percentage of GDP; (ii) percentage of enterprises with loans or credit lines; (iii) number of fourth-generation concession contracts reaching financial close; (iv) credit to the agriculture sector over agriculture sector GDP; (v) average value of collateral required to obtain a loan, in proportion to the amount of the loan; (vi) new issues listed on the stock exchange; (vii) change in the average spread between lending and borrowing rates; (viii) percentage of adults who have at least one financial product; (ix) simple average of minimum balances in savings accounts in large banks; and (x) percentage of MSMEs with a bank loan or credit line. For further details, see the Results Matrix.

D. Economic analysis

1.31 The economic analysis gauges the impact of the reforms based on the medium-term growth rate. Calculations are based on a general equilibrium model of financial development proposed by Dabla-Norris et al. (2014)[39] and calibrated for Colombia by Karpowicz (2014).[40] The sensitivity of the principal results to a wide range of parameters was measured. Real benefit flows, discounted at a rate of 12%, show positive results of US$10 billion, with a high degree of tolerance in the sensitivity scenarios. To evaluate the program impacts, the use of a general equilibrium model is proposed, since there is already a calibration for Colombia showing that such a model is viable. Moreover, the availability of data needed to recalibrate the model with values for 2019 has already been confirmed with the corresponding World Bank authorities (see details in the program Economic analysis).

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instrument

2.1 This is the second of two consecutive operations that are technically interconnected but financed independently under the programmatic policy-based loan (PBP) modality. This operation is for up to US$450 million, and consists of US$400 million from the Bank's Ordinary Capital resources, and US$50 million in resources from the China Cofinancing Fund for Latin America and the Caribbean, which is administered by the Bank. The selection of the programmatic modality as a financing instrument is aligned with document CS-3633-1, "Policy-Based Loans: Guidelines for preparation and implementation," in order to facilitate a policy dialogue between the country and the Bank, establish the necessary timelines to implement the reforms, and provide an opportunity to evaluate the progress achieved in the first operation and make any necessary adjustments to the

---

39 Dabla-Norris, Era; Ji, Yan; Townsend, Robert; and Filiz Unsal, *Financial Deepening, Growth, and Inequality: A Structural Framework for Developing Countries,* 2014.

40 Karpowicz, Izabela, *Financial Inclusion, Growth and Inequality: A Model Application to Colombia,* No. 14-166, International Monetary Fund, 2014.

reforms, based on the knowledge acquired. This second operation effectively builds upon the actions initiated in the first operation.

2.2 **Dimensioning of the operation.** In accordance with the provisions of paragraph 3.27, subparagraph (b), of document CS-3633-1, the operation was sized to fit the country's fiscal resource needs. For 2017, the central government's financing requirements are equivalent to 6.5% of GDP, and the loan amount of this operation is intended to cover part of this financing, i.e., 2.1% of total financing requirements, and 15% of financing from multilateral sources. According to macroeconomic analyses,[41] the outlook for Colombia is stable, and debt sustainability analyses indicate that total public debt as a percentage of GDP will decrease in the medium term and will remain manageable, even in the event of major adverse external shocks.

B. Environmental and social safeguard risks

2.3 In accordance with Directive B.13 of the Bank's Environment and Safeguards Compliance Policy (document GN-2208-20, Operational Policy OP-703), this operation does not require classification, since the proposed reforms have no adverse environmental or social impacts.

C. Other project risks

2.4 The fiscal sustainability risk is rated "medium." To mitigate its impact on the measures to be implemented in this operation, the project team will conduct monitoring activities with periodic reports on the country's fiscal situation in a tax reform environment, including its impact on the measures. In addition, to mitigate the impact on the economy, the authorities have approved a flexible credit line with the IMF. To ensure fiscal sustainability, the reforms have been designed to provide benefits without placing a burden on public finances. Moreover, the program goals are aligned with the objectives of the National Development Plan 2014-2018, as well as with the road map established for Colombia's accession to the OECD.

2.5 Since this is the second and final operation in the programmatic series, the importance of the reforms undertaken in these two operations as part of an ongoing medium-term effort on the part of the Colombian government must be stressed. Under the conditions for Colombia's accession to the OECD, the country must meet transparency and consolidated regulation standards for the financial system. In the context of the Pacific Alliance, Colombia has undertaken the commitment to gear its financial integration policies specifically to the securities market. This latter issue is also considered in the National Development Plan 2014-2018, which underscores the importance of financial inclusion and infrastructure investment, among other issues. In view of the foregoing, there is a natural continuity in the financial system reform agenda, in terms of investment operations for financing SMEs, the agriculture sector, and infrastructure projects in future public-private partnerships, as well as in terms of support for future reforms in the capital market, improved regulation and supervision of the financial system, and financial inclusion.

[41] IMF, *Article IV Consultation – Staff Report*, April 2016.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 The executing agency will be the Ministry of Finance and Public Credit (MHCP), which will implement the program in coordination with the National Planning Department (DNP), acting as technical coordinator, and other entitles involved in execution. It will monitor progress toward fulfillment of the program conditions through six-monthly monitoring meetings with representatives of the entitles involved and delivery of a six-monthly report to the Bank. Given the coordination role played by the MHCP's Financial Regulation Unit with respect to financial regulation in Colombia, its role as technical coordinator for this operation is naturally aligned with the requirements for enforcing the proposed means of verification to ensure effective monitoring.

3.2 Special contractual conditions precedent to the sole disbursement of the loan proceeds. The disbursement of the Bank loan proceeds will be subject to the borrower's fulfillment, to the Bank's satisfaction, of the policy reform commitments described in the program components and detailed in the Policy Matrix (see Annex II), and fulfillment of the other conditions established in the loan contract.

B. Summary of arrangements for monitoring results

3.3 Implementation of the program will be monitored by the MHCP's Financial Regulation Unit. The borrower and the Bank will hold six-monthly meetings to review fulfillment of the conditions required for the program. In particular, the MHCP will be responsible for compiling the information needed for the supervision of the program, in order to monitor the Means of Verification Matrix and the indicators included in the Results Matrix.

3.4 At the end of the program, the Bank will prepare a project completion report and an ex post evaluation based on a general equilibrium model, focused on three dimensions of financial expansion—scope, depth, and efficiency—, in order to gauge the impact on the economic growth of the financial system following implementation of the reforms. For further details, see the Monitoring and evaluation plan.

IV. POLICY LETTER

4.1 The Policy Matrix for the program (Annex II) is aligned with the Policy Letter issued by the Republic of Colombia, in which the government reaffirms its commitment to implement the activities agreed upon with the Bank.

Development Effectiveness Matrix		
Summary		
I. Corporate and Country Priorities		
1. IDB Development Objectives	**Yes**	
Development Challenges & Cross-cutting Themes	**-Social Inclusion and Equality -Productivity and Innovation -Economic Integration -Institutional Capacity and the Rule of Law**	
Country Development Results Indicators		
2. Country Development Objectives	**Yes**	
Country Strategy Results Matrix	**GN-2832**	**Spur innovation and development in business and agriculture.**
Country Program Results Matrix	**GN-2884**	**The intervention is included in the 2017 Operational Program.**
Relevance of this project to country development challenges (If not aligned to country strategy or country program)		
II. Development Outcomes - Evaluability	**Evaluable**	
3. Evidence-based Assessment & Solution	**9.0**	
3.1 Program Diagnosis	**2.4**	
3.2 Proposed Interventions or Solutions	**3.6**	
3.3 Results Matrix Quality	**3.0**	
4. Ex ante Economic Analysis	**8.0**	
4.1 The program has an ERR/NPV, a Cost-Effectiveness Analysis or a General Economic Analysis	**2.5**	
4.2 Identified and Quantified Benefits	**2.0**	
4.3 Identified and Quantified Costs	**2.0**	
4.4 Reasonable Assumptions	**0.0**	
4.5 Sensitivity Analysis	**1.5**	
5. Monitoring and Evaluation	**8.1**	
5.1 Monitoring Mechanisms	**1.5**	
5.2 Evaluation Plan	**6.6**	
III. Risks & Mitigation Monitoring Matrix		
Overall risks rate = magnitude of risks*likelihood	**Low**	
Identified risks have been rated for magnitude and likelihood	**Yes**	
Mitigation measures have been identified for major risks	**Yes**	
Mitigation measures have indicators for tracking their implementation	**Yes**	
Environmental & social risk classification	**B.13**	
IV. IDB´s Role - Additionality		
The project relies on the use of country systems		
Fiduciary (VPC/FMP Criteria)	**Yes**	**Financial Management: Budget, Treasury, Accounting and Reporting, External Control, Internal Audit.**
Non-Fiduciary		
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:		
Gender Equality	**Yes**	**The program will support knowledge generation, including, among others, a diagnostic of the regulations for financial services with a gender view. These findings could be a benefit in the future to understand whether there is a problem that should be addressed.**
Labor		
Environment		
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project	**Yes**	**The following technical assistance was provided in support of: i) the Finance Superintendent Agency (Superintendencia Financiera) ATN/FI-12889-RG, ATN/OC-14371-RG, ART/OC-13779-RG, and ATN/SF-9621-RG; ii) the executing agency National Finance Development Agency (Financiera de Desarrollo Nacional) ATN/OC-14753-CO; and iii) the Treasury (Ministerio de Hacienda y de Crédito Público) ATN/AA-14960-RG and ATN/OC-14689-RG.**
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan	**Yes**	**A general equilibrium model has been adapted in order to be able to concretely understand the impact of these reforms specifically for Colombia. This exercise has been done jointly with the IMF, and if it weren't for this program the effort to adapt this model to understand the magnitude of benefits for the country would not have been undertaken. This exercise will also be validated ex-post.**

Note: (*) Indicates contribution to the corresponding CRF's Country Development Results Indicator.

The Support Program for the Reform of the Financial System of Colombia II (CO-L1214) is the second of two programmatic loans supporting political reforms. The objective of this program is to improve the financial sector's contribution to the economic growth of Colombia, through: (i) increased financing for productive development; (ii) improvements in the regulation and supervision of the financial system to support the development of capital markets and financial transparency; and (iii) improvements in the financial inclusion of the unbanked citizens and SMEs.

The project's vertical logic is consistent. It provides the diagnosis of challenges to be resolved, including low financial penetration among smaller firms –due in part to high guaranties; bank supervision and regulation in need of strengthening; limited liquidity of the capital markets; and low participation of citizens in the formal systems of saving and credit. The proposed activities and outputs (laws, regulations, stronger institutions, etc.) are aligned with the challenges identified and aim at setting the normative and institutional basis to reduce the participation costs of firms and citizens, reducing the barriers to financing for economic activity. The indicators of the results matrix will allow to monitor outputs and to measure the results of the reform through the proposed evaluation.

Both the economic analysis and the evaluation plan rely on a micro-founded general equilibrium model developed by the International Monetary Fund (IMF) to measure the effect of this type of program. The model allows simulating the evolution of relevant variables (like economic growth) affected by changes in the parameters of interest (requirement level of the guarantees, cost of participation, etc.). The advantage of access to the model is twofold: first, the necessary information for the estimations exists and is updated frequently enough to follow the program according to the monitoring and evaluation plan; second, there is a group of IMF officials who can provide support and suggestions for the calibrations and simulations. The disadvantage is that, at least for now, the quantitative exercises are performed by those officials, which limits the possibility to learn with higher accuracy the dynamics and orders of magnitude of the effects of the interactions of the variables in the model.

POLICY MATRIX

Policy objectives	Policy measures agreed upon for Program I	Policy measures agreed upon for Program II
Component I: Macroeconomic stability		
a. Maintain a macroeconomic environment consistent with the program objectives and with the guidelines of the sector policy letter.	The macroeconomic environment is consistent with the program objectives and with the guidelines of the sector policy letter.	The macroeconomic environment continues to be consistent with the program objectives and with the guidelines of the sector policy letter.
Component II: Improvements in financing for productive development and public-private partnerships		
a. Strengthening the guarantee systems for productive development.	(i) Measures for improving access to productive financing by Colombian firms have been adopted, including, at a minimum, the following: • The law promoting access to credit and mandating standards on personal-property collateral (Law on Secured Transactions) has been approved by the National Congress and has entered into effect. • The decree regulating the functioning of the Registry of Secured Transactions has been issued by the national government (Ministry of Trade, Industry, and Tourism). • The registration forms and fees for the Registry of Secured Transactions have been approved by the Ministry of Trade, Industry, and Tourism. • The Law on the National Development Plan 2014-2018 creating the Master Registry of Electronic Invoicing has been enacted by the National Congress. • The draft decree regulating the conditions for the expansion of	(i) Measures for improving access to productive financing by Colombian firms have been adopted, including, at a minimum, the following: • The decree regulating the enforcement of secured transactions by loan institutions has been issued by the National Government (MHCP). • The circular on mechanisms for assessing the value of secured transactions has been issued by the Financial Superintendency. • The decree regulating the functioning of the Registry of Secured Transactions has been issued by the national government (Ministry of Trade, Industry, and Tourism). • The decree regulating the expansion of electronic invoicing has been issued by the national government (MHCP).

Policy objectives	Policy measures agreed upon for Program I	Policy measures agreed upon for Program II
	electronic invoicing has been prepared and published for public consultation by the Ministry of Finance and Public Credit (MHCP).	
b. Strengthening public institutions for financing productive development and public-private partnerships.	(i) Measures to strengthen the capacity of Financiera de Desarrollo Nacional (FDN) have been adopted, in order to facilitate greater access to finance for infrastructure projects. The measures include: • The bylaws of FDN have been amended, as approved at a special session of the General Meeting of Shareholders. • The National Declaration, through which the nation commits, as the majority shareholder in FDN, to ensure the application of best practices in corporate governance at FDN, has been issued by the MHCP. • The decree modifying the maximum amount of individual loans for FDN has been issued by the national government (MHCP). (ii) Measures for access to productive financing by the agriculture sector have been adopted, including at a minimum: • The law on financing for the revitalization of the agriculture sector has been approved by the National Congress. • Circulars on operating regulations for the Agriculture Guarantee Fund have been issued by the Agriculture Sector Financing Fund.	(i) Measures to strengthen the capacity of Financiera de Desarrollo Nacional (FDN) have been adopted, in order to facilitate greater access to finance for public-private partnership infrastructure projects, including at a minimum: • Financial close documents on fourth-generation concession contracts have been concluded by FDN, making use of new financial instruments. (ii) Measures for access to productive financing by the agriculture sector have been adopted, including at a minimum: • The decree regulating financing for the revitalization of the agriculture sector has been issued by the national government (Ministry of Agriculture and Rural Development). • The decree revising credit concentration limits for the Agriculture Sector Financing Fund with entitles to which it conducts discounting has been issued by the national government (MHCP).

Policy objectives	Policy measures agreed upon for Program I	Policy measures agreed upon for Program II
		• The circular expanding the spectrum of insurance policies for the agriculture sector has been issued by the Financial Superintendency.
Component III: Improvements in the regulation and supervision of the financial system		
a. Strengthening regulation and supervision to ensure a sounder and deeper financial system.	(i) Measures aimed at deepening the development of the financial system have been adopted, including, at a minimum, the following: • The decree reforming the regulatory framework of the secondary market, containing a simplification of documentation requirements for issuers in the secondary market, has been issued by the national government (MHCP). • The draft decree modifying the international investment regime has been published by the MHCP for public consultation. • The decree that includes hybrid instruments for capitalizing credit institutions has been issued by the national government (MHCP). • The circular presenting the New Code of Corporate Best Practices of Colombia (Country Code) and establishing the obligation for entities that issue securities to prepare and submit a report on its implementation has been issued by the Financial Superintendency.	(i) Measures aimed at deepening the development of the financial system have been adopted, including, at a minimum, the following: • The decree amending the provisions related to the general international capital investment regime in Colombia and Colombian investments abroad has been issued by the national government (MHCP). • The decree amending the provisions on exceptions to the definition of public offer of securities and tap issues has been issued by the national government (MHCP). • The draft law mandating regulations to strengthen the regulation and supervision of financial conglomerates and mechanisms for the resolution of financial institutions has been submitted to the National Congress for review and approval. • The decree revising the provisions on the appointment and removal of the Financial Superintendent has been issued by the national government (Administrative Department of the Civil Service). • The decree revising the provisions related to the forced administrative

Policy objectives	Policy measures agreed upon for Program I	Policy measures agreed upon for Program II
		liquidation process and payment of FOGAFIN deposit insurance has been issued by the national government (MHCP). • The draft decree related to adequate assets of pension and unemployment fund management firms, brokerage firms, and investment management firms has been published by the MHCP for comment. • The Guidelines on Risk Assessment Criteria have been issued by the Financial Superintendency.
	(ii) Mechanisms have been adopted for improving protections for investors in capital markets, including, at a minimum: • The decree on price stabilization mechanisms has been issued by the national government (MHCP). • The decree revising the provisions on individual credit limits, investment regimes involving resources from unemployment funds, mandatory pension funds, and portfolios that back the technical reserves of life insurance companies, and partially amending the definition of private capital funds within the private capital fund investment regime directed at infrastructure investments as part of public-private partnerships, has been issued by the national government (MHCP). • The draft decree amending provisions on the administration of third party	(ii) Mechanisms have been adopted for improving protections for investors in capital markets, including, at a minimum: • The decree revising the provisions on the administration of third party portfolios has been issued by the national government (MHCP). • A study has been conducted on advisory activities in the securities market, which includes a regulatory analysis of such activities, the expansion of fixed income financial instruments and derivatives as part of efforts to increase the integration of financial markets with the Latin American Integrated Market (MILA), and the expansion of the contracts of correspondent institutions and representative offices offering foreign capital market products; and this study has been published by the MHCP.

Policy objectives	Policy measures agreed upon for Program I	Policy measures agreed upon for Program II
	portfolios has been published by the MHCP for public consultation.	
b. Strengthening financial transparency	(i) Measures to improve financial transparency mechanisms for users of the financial system have been adopted, including, at a minimum, the following: • The Basic Legal Circular has been updated by the Financial Superintendency with instructions applicable to supervised institutions. • The decree on the solvency of factoring and invoice discounting firms has been issued by the national government (MHCP and the Ministry of Trade, Industry, and Tourism). • The law establishing the obligation to provide transparent information to consumers of financial services has been approved by the National Congress. • The draft decree on price transparency in the general pension system has been published by the MHCP for comment. • The draft decree on price transparency for customers of credit institutions has been published by the MHCP for comment. • The Circulars on convergence with International Financial Reporting Standards have been issued by the Financial Superintendency.	(i) Measures to improve financial transparency mechanisms for users of the financial system have been adopted, including, at a minimum, the following: • The decrees amending provisions on the protection regime for financial consumers participating in the general pension system in order to achieve price transparency has been issued by the national government (MHCP). • The decree on price transparency for customers of credit institutions has been issued by the national government (MHCP). • The Circulars on International Financial Reporting Standards have been issued by the Financial Superintendency, based on updates by the International Accounting Standards Board.
Component IV: Improvements in financial inclusion		
a. Improving the supply of products and channels for financial inclusion	(i) Measures to expand access to financial services for the excluded or recently	(i) Measures to expand access to financial services for the excluded or recently

Policy objectives	Policy measures agreed upon for Program I	Policy measures agreed upon for Program II
	included population have been adopted, including, at a minimum, the following: • The law promoting access to transactional financial services (Law on Financial Inclusion) has been enacted by the National Congress. • The draft decree regulating the Law on Financial Inclusion has been published for public consultation, and regulations for simplifying the procedures for savings accounts and electronic deposits have been published by the MHCP for comment. • The decree creating small consumer loans has been issued by the national government (MHCP). • The resolution certifying the current bank interest rate for the small consumer loan modality has been issued by the Financial Superintendency. • The decree authorizing the distribution of insurance through the network of correspondent banks has been issued by the national government (MHCP). • The resolution regulating fees for access to mobile financial services has been issued by the Communications Regulatory Commission.	included population have been adopted, including, at a minimum, the following: • The decree regulating the Law on Financial Inclusion has been issued by the national government (MHCP). • The resolution certifying the current bank interest rate for the small consumer loan modality has been updated by the Financial Superintendency. • Assessments of tax barriers to the formalization and creation of payment ecosystems and to incentivize digital payments, prepared by the Financial Regulation and Financial Studies Unit (URF) have been conducted and published by the MHCP, and the simplified regime for small taxpayers has been created. • An assessment of financial system regulations for expanding women's access to financial services has been conducted. • The study assessing the insurance marketing program in Colombia has been prepared by the URF.
b. Improving the institutional structure for increasing financial inclusion	(i) Measures have been adopted to strengthen the coordination of government entities involved in promoting financial inclusion and economic and financial education, including, at a minimum, the following: • The draft decree creating and	(i) Measures have been adopted to strengthen the coordination of government agencies involved in promoting financial inclusion and economic and financial education, including, at a minimum, the following: • The decree creating and establishing

Policy objectives	Policy measures agreed upon for Program I	Policy measures agreed upon for Program II
	establishing an intersectoral commission for financial inclusion has been published by the MHCP for public consultation. • The decree creating and establishing an intersectoral commission for economic and financial education has been issued by the national government (MHCP, the Ministry of National Education, and the Administrative Department of the Civil Service). • The circular letter on the reporting requirement for evaluating financial inclusion in the insurance industry has been issued by the Financial Superintendency.	an intersectoral commission for financial inclusion has been issued by the national government (MHCP). • Colombia's National Strategy on Economic and Financial Education (ENEEF) has been prepared by the Intersectoral Commission for Economic and Financial Education.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/17

Colombia. Loan ____/OC-CO to the Republic of Colombia
Financial System Reform Support Program II

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Colombia, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a financial system reform support program. Such financing will be for the amount of up to US$400,000,000 from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on ___________)

LEG/SGO/CAN/CO-IDBDOCS#40864666
CO-L1214

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/17

Colombia. Loan ____/CH-CO to the Republic of Colombia
Financial System Reform Support Program II

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, acting as Administrator of the China Co-financing Fund for Latin America and the Caribbean, to enter into such contract or contracts as may be necessary with the Republic of Colombia, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a financial system reform support program. Such financing will be for the amount of up to US$50,000,000 from the resources of the China Co-financing Fund for Latin America and the Caribbean, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on ___________)

LEG/SGO/CAN/CO-IDBDOCS#40864667
CO-L1214

FINANCIAL SYSTEM REFORM SUPPORT PROGRAM II

CO-L1214

CERTIFICATION

The Grants and Co-Financing Management Unit (ORP/GCM) certifies that the operation received the non-objection for financing by the **China Co-Financing Fund for Latin America and the Caribbean (CHC**) for the amount of up to **US$50,000,000** confirmed by Xintong Liu of the State Administration of Foreign Exchange (SAFE), February 28, 2017.

Original Signed	*April 12, 2017*
Sonia M. Rivera Chief Grants and Co-Financing Management Unit ORP/GCM	Date