Box 2: Results of the International Monetary Fund/ World Bank's Colombian Financial Sector Assessment Program

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1. Introduction: evaluation programs

Throughout 2021, *Banco de la República* participated, together with the other safety net authorities of the Colombian financial system, in the Financial Sector Assessment Program (FSAP) coordinated by the International Monetary Fund (IMF) and the World Bank (WB). This box briefly describes the main results of the program, which could possibly serve as material for a potential agenda of financial system reforms in Colombia.

According to the IMF,[1] an FSAP seeks to provide a "comprehensive and in-depth analysis of a country's financial sector" by assessing the stability and soundness of the financial system and its potential contribution to the growth and development of the economy. Since 1999, 113 countries have participated in a total of 240 FSAPs, which indicates how these programs have become a routine evaluation exercise for a large number of jurisdictions. Colombia has participated in three FSAPs to date (2004, 2012, and 2021). Although these programs were scheduled by the Colombian authorities on a voluntary basis, the country joined the list of IMF member jurisdictions that must carry out at least one FSAP every ten years as of 2021 due to the systemic importance of the Colombian financial sector.[2]

In practice, an FSAP consists of cycles of meetings between the IMF and the WB, on the one hand, and financial system safety net authorities, financial institutions, other government bodies, and service providers, on the other. At these meetings, the participants' views on the characteristics of the financial system, the regulations, and functioning of the sector are discussed, weaknesses and strengths are identified, and methodologies and quantitative financial stability assessment exercises used locally are presented. At the same time, participants share an extensive set of information on the system with the IMF and the WB. Based on these meetings, and using the information shared as input, the IMF and the WB publish an assessment containing the results of both their qualitative analysis and quantitative exercises based on methodologies and scenarios that have been previously discussed with local authorities. The results include a set of policy recommendations for financial authorities.

2. Main results of Colombia's FSAP in 2021

In April 2022, the IMF and the WB published the results of the FSAP done for Colombia during 2021. These results are presented in two papers (IMF and WB, 2022 and IMF, 2022): First, the IMF published the results of its Financial System Stability Assessment (FSSA), which includes its assessment of the frameworks for banking supervision, macroprudential policy, resolution, and crisis management as well as its quantitative stress tests of the financial system's ability to cope with adverse scenarios on different risk fronts. Second, the IMF and the WB publish the results of the Financial Sector Assessment (FSA), which, in

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1 See https://www.FMI.org/es/About/Factsheets/Sheets/2016/08/01/16/14/Financial-Sector-Assessment-Program

2 The IMF established a list in 2010 of 25 jurisdictions with systemically significant financial systems (mainly advanced economies) that were required to have at least one FSAP every five years. The list was expanded to 29 countries in 2013. A new list of countries that, since they have financial systems with some systemic importance, will be required to have at least one FSAP every ten years was added to this list (expanded to 32 jurisdictions) in 2021. The IMF placed Colombia on the latter list, which is mainly composed of emerging economies.

addition to reiterating the results of the FSSA, has a special focus on aspects of the overall development of the financial system.

3. Stability of the Financial System

Colombia's FSSA results reflect progress in banking supervision, the strengthening of resolution and crisis management mechanisms, and the effectiveness of the macroprudential policy framework. The evaluation also highlights the financial system's ability to cope with sudden shocks to its capital and liquidity.

With regard to banking supervision, the evaluation highlights recent progress in terms of operational independence and integrated functions of the Office of the Financial Superintendent of Colombia (FSC), the establishment of a supervisory framework for financial conglomerates, and the convergence of financial regulation with international standards. At the same time, the evaluation recommends strengthening the independence of the FSC (for example, establishing minimum terms of office for the superintendent by law, explicit grounds for removal, and legal protection for supervisory tasks), establishing a consolidated framework of regulatory requirements for transactions between related counterparties,[3] and aligning the parameters of the liquidity risk indicator (LRI) and of the net stable funding ratio (NSFR) with those established by international standards.

In the area of crisis resolution and management mechanisms, the IMF recognizes the significant progress in what has been implemented since 2015. In that respect, the recommendations made by the FSSA include maintaining the agenda of improvements and adjustments in resolution processes (e.g., expanding the use of recovery and resolution plans, or consideringbail-in mechanisms, within the list of resolution tools). Two aspects in which the FSSA was particularly critical of the current system are the presence of the Financial Institutions Guarantee Fund (Fogafín) as a shareholder of bridge banks[4] and the need for mechanisms to strengthen the protection of the financial situation of this institution (e.g., by guaranteeing its access to lines of credit with foreign agents).

According to the evaluation, the macroprudential policy framework in Colombia (involving the national government, *Banco de la República*, and Fogafin) has been effective in containing the emergence of financial imbalances while Colombian authorities have developed an advanced framework for monitoring systemic risks. In this regard, the FSSA proposes three areas for improvement: first, making progress in the collection of key information for the analysis of financial stability (especially in the areas of household indebtedness and cross-border linkages of local financial institutions). Second, strengthening the role of *Banco de la República* in systemic risk monitoring (e.g., in policy discussions within the Committee for the Coordination and Surveillance of the Financial System) and authorizing a joint mandate (with the FSC) on some existing macroprudential tools.[5] Finally, expanding the macroprudential toolkit, including instruments that would make it possible to control specific risks (for example, a NSFR requirement at the consolidated level to mitigate risks arising from cross-border exposures, and limits on the loan-to-value ratio for leasing operations, or limits on the debt-to-income ratio for the non-morgage household portfolio to mitigate credit risks) and studying the adoption of a countercyclical capital requirement to complement the current countercyclical loan-loss provision model.

In addition to these thematic reflections, the IMF presents in the FSSA several quantitative stress tests that seek to assess the capability of the Colombian financial system to deal with adverse scenarios on several risk fronts: capital adequacy, liquidity, interconnectedness and contagion, corporate debt, and climate change.[6] In line with the results obtained in Chapter 3 of this Report, the FSSA concludes that the Colombian system has the ability

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3 In this regard, the national government is currently working on a draft decree.

4 The IMF argues that there could be a conflict of interest between Fogafín as a shareholder and Fogafín as the resolution arm of a bridge bank. In contrast to this argument, in practice it is likely that a bridge bank will always require the State's shareholding precisely because those assets and liabilities that other potential shareholders did not acquire (presumably because of their high risk) are transferred to such entities.

5 For example, the limits on the loan-to-value (LTV) ratio of the housing portfolio currently established by the National Government.

6 Stress tests to assess the risks associated with climate risk were published in Perez-Archila and Sever (2021), and Reinders, Calice, and Escobar (2021).

at the individual level to continue providing its services even if it were to experience profoundly adverse situations on those risk fronts. Nevertheless, the presence of a minority number of consistently vulnerable entities, the complexity of cross-border exposures, the high exposure of the system to corporate debt, and the acceleration of climate change highlight the need to make progress in systemic risk monitoring on an ongoing basis.

4. Development of the Financial System

The evaluation of the overall development of the financial system included aspects of competition, digital financial inclusion, the role of the State in the sector, and the development of the capital market, among others. The results simultaneously identify a broad set of advances and challenges in promoting the development of the Colombian financial system.

In terms of competition, the FSA concludes that in the Colombian financial system a high concentration of business coexists with competitive forces although the latter are more prevalent in specific segments such as consumer loans. Going forward, competition in the sector could be further affected by the presence of financial conglomerates, the creation of Grupo Bicentenario as the country's third largest financial conglomerate[7], and vertical integration in the payment system. Therefore, the IMF and the WB recommend strengthening and articulating (possibly through memorandums of understanding) the actions of the FSC and the Superintendency of Industry and Commerce regarding competition in the financial sector, and developing tools to include aspects of competition in the evaluation of reforms to financial regulation and supervision. At the same time, the FSA notes that there is a low frequency of sanctions for anti-competitive practices in the financial sector, and therefore recommends reviewing the procedures for evaluating mergers and acquisitions in the sector as well as strengthening the surveillance and enforcement capabilities of the authorities involved.

The evaluation highlights the commitment of public policy to the goal of financial inclusion, which has made it possible to make progress in the goal of connecting broader sectors of the population to the services provided by the financial system. Significant lags and inequalities persist in the area of digital payments, exacerbated by the lack of access to critical digital infrastructure. Therefore, the FSA recommends pressing ahead with structural reforms to establish more effective institutional mechanisms: the creation of a National Payments Council and the adoption of flexible and modern regulatory systems, together with the strengthening of competition in the use of the payment infrastructures (which, ultimately, may require the participation of *Banco de la República's* infrastructure).

Regarding direct state participation in the financial sector, along with the recommendation to quickly formalize the Bicentennial Group and move forward in the governance of state financial institutions (to, among other things, strengthen their mandate to advance financial inclusion), the FSA recommends a structural evaluation of interest rate limits in the financial sector (including usury rates, limits on agricultural credit rates, and the maximum remuneration rate for housing loans), and of the mandatory investments currently in place (including Agricultural Development Securities and Solidarity Securities). The above is intended to ensure that the regulation of maximum rates and mandatory investments does not distort the development of private credit markets.

Finally, the FSA admits that the Colombian capital market, despite its recent development and the depth and liquidity of public debt markets, is "shallow, illiquid, dominated by only a few institutions", such that it "limits investment and growth". At the same time, the evaluation highlights the presence of an ongoing reform agenda and, in addition to recommending that it be expedited, highlights the need to resume efforts to eliminate the tax on financial transactions, rule out early withdrawals from private pension funds (which, according to the evaluation, could affect financial stability[8] and limit the options for some agents to obtain long-term financing), make the application of Law 2112/2021 (which imposes a mandatory investment in private equity funds on pension and severance fund management companies) more flexible, and redefine the concept of "equity detriment"

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7 According to the assessment, the state ownership of the Group could affect the ability of the private sector to compete on a level playing field.

8 For an alternative analysis of the issue, see Box 1 of the *Financial Stability Report* for the second half of 2020.

in the management of public assets which, in practice, has the effect of limiting feasible investment options for administrators.

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