Project Information Document/ Integrated Safeguards Data Sheet (PID/ISDS)

Concept Stage | Date Prepared/Updated: April 10, 2017| Report No: 114421

BASIC INFORMATION

A. Basic Project Data

Country:	Colombia	**Project ID:**	P162915
		Parent Project ID *(if any)*:	
Project Name:	Guarantee to Strengthen Financial Safety Net		
Region	LAC		
Estimated Appraisal Date:	June 29, 2017	**Estimated Board Date:**	November 10, 2017
Practice Area (Lead):	Finance & Markets	**Lending Instrument:**	IBRD Guarantees
Sector(s):	Finance & Markets (100%)		
Theme(s):	Strengthening the financial safety net (100%)		
Borrower(s)	FOGAFIN		
Implementing Agency	FOGAFIN		
Financing (in USD Million)			
Financing Source			

Total Financing	1,000	USD million
Of which IBRD Guaranteed tranche	120-500	USD million
Additional financing mobilized	500-800	USD million
Of which MIGA guaranteed tranche	500-800	USD million

Environmental Category	C-No environmental aspects or impacts
Concept Review Decision	To go ahead with project preparation
Is this a Repeater project?	No
Other Decision (as needed)	

B. Introduction and Context

Country Context

1. **Sound macroeconomic and structural policies, coupled with favorable external conditions, enabled a strong broad-based growth and poverty reduction in the last decade. However, the oil price shock has dampened growth.** Between 2004 and 2014, average annual growth reached 4.8 percent, making Colombia one of the strongest performers in Latin America. Its sound macroeconomic management, based on a combination of an inflation targeting regime, floating exchange rate, and strong track record of fiscal discipline, helped the country weather the global financial crisis of 2008-9, and together with strong oil prices, enabled a remarkable bounce back between 2009 and 2013. Strong external demand, and global low interest rates also helped to boost foreign direct investment (FDI), exports, and Government revenues. At the same time, the authorities implemented targeted structural reforms to gradually improve the country's regulatory system and reduce factor and product market rigidities. Extreme poverty fell from 17.7 percent in 2002 to 7.9 percent in 2015, while total poverty fell from 49.7 percent in 2002 to 27.8 percent in 2015. However, due to the fall in oil prices, growth slowed to 3.1 percent in 2015 and 2.0 percent in 2016.

2. **The Colombian authorities continue to adhere to a sound macroeconomic policy framework in response to the unfavorable external environment.** Colombia has faced the downturn with some monetary and fiscal cushions. Its flexible exchange rate was the first line of defense against the terms of trade shock stemming from lower oil prices and softer external demand. When the depreciation passed through to the broader economy, the monetary authorities began to hike interest rates to tame inflation, showing strong commitment to maintaining price stability. In response, inflationary pressures started to ease in August 2016. The authorities also used a mix of revenue enhancing and expenditure reducing measures to partly compensate for the loss in fiscal revenues from the oil sector and increased debt interest payments due to depreciation[1], while allowing the fiscal deficit to increase within the parameters set by the Fiscal Rule (which targets the structural fiscal deficit). In order to adhere to the Fiscal Rule's fiscal consolidation path, a reduction of 3 percent of Gross Domestic Product (GDP) would be required between 2016 and 2022. A tax reform approved in December 2016, and supported by a World Bank operation, is expected to increase revenue by 0.7 percentage points of GDP in 2017. In conjunction with concomitant expenditure cuts, it is envisaged that Colombia will meet the targets prescribed in the Fiscal Rule.

Sectoral and Institutional Context

3. **Colombia's financial system is mainly bank-based and has grown considerably over the past decade in depth and breadth.** Colombia's financial system has a banking sector comparable to countries of similar per capita GDP, size, and demographics although capital markets intermediation to the private sector remains below potential. Supervised financial system assets (banking, insurance, pensions, credit unions, and private equity) have grown from 60 percent of GDP in 2011 to over 100 percent of GDP in 2015. The majority of this growth has been deposit-driven, with limited foreign borrowing. In 2014, 38 percent of adults in Colombia had an account at a formal financial institution, up from 30 percent in 2011. The gender differences in Colombia are muted in comparison to parts of Africa and South Asia, with 34 percent of adult females reporting having an account at a formal financial institution.

[1] Both effects combined amounted to 3 percent of GDP between 2013 and 2015.

4. **Domestic conglomerates, increasingly operating cross–border in Central America, dominate the financial landscape.** Currently, there are 36 conglomerates with a strong presence in the financial system, with many of them operating in the real sector, as well. These entities typically comprise one or more banks, leasing companies, financial corporations, insurance companies, pension fund administrators, and real sector companies. Ten of these conglomerates hold about 80 percent of total financial sector assets and some of them also include real sector activities. In the banking sector, the percentage of assets held by the top three banks (Bancolombia S.A., Banco de Bogota S.A., and Davivienda S.A) has remained largely stable at around 50 percent in the last three years. This percentage rises to 62 percent if the four banks owned by the Grupo Aval conglomerate are categorized as a single bank. Over the past five years, there has been a significant expansion of Colombian banks into the Central American banking market. Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama have all seen the entry of both Banco de Bogota under the name of Banco de America Central, while Davividenda has entered into four of the above markets, and Bancolombia into two. As of June 2015, the total assets of Colombia's financial conglomerates in the Central American financial system stood at 28 percent of GDP. This is over a quarter of the Central American total banking system assets. Cross border operations have altered the risk profile of conglomerates (e.g. foreign exchange and country risk) and have required substantial upgrading of the oversight framework.

5. **Financial soundness indicators remain adequate, despite some deterioration in the last year due to economic downturn.** The banking system remains well-capitalized, with a Capital Adequacy Ratio (CAR) of 15.5 percent in September 2016, albeit down from 17 percent in 2014. On a consolidated basis (including exposures to Central America) CAR is somewhat lower, however, still at comfortable levels. With monetary tightening over the last year, credit growth to the private sector slowed from 18.1 percent (year-on-year) in December 2015 to 5.3 percent in August 2016. Non-performing loans (NPL) have increased slightly in recent months, to 3.3 percent (September 2016), and the impact of rising unemployment and lower real income (owing to high inflation) could trigger further deterioration in the quality of consumer loans and mortgages during 2016-2017[2].While still relatively high, profitability declined slightly in the past months with Return on Equity (ROE) at 18 percent (September 2016), partly reflecting the concentration of the banking sector.

6. **In recent years, authorities have implemented a comprehensive agenda to strengthen the financial safety net with World Bank support, in response to increased internationalization and complexity of the financial sector.** Globally, the financial safety net rests on three pillars: financial sector oversight, adequate resolution framework for financial institutions, and sufficient financial resources to resolve failed institutions. In line with the recommendations of the 2012 Financial Sector Assessment Program (FSAP), the authorities have revised capital regulations to enhance quality of capital in line with Basel standards and have given new supervisory powers that allow the Financial Superintendent (SFC) to request additional capital (beyond the regulatory minimum) according to bank risk profiles. The structure of the SFC is being revised to facilitate supervision of conglomerates in a more comprehensive and integrated way. Draft legislation currently under discussion in Congress will bring conglomerate holdings under the regulatory perimeter (a key recommendation of the FSAP, with a view to prevent double-gearing and to ensure the integrity of reported capital). The law also introduces the "bridge-bank" figure, a bank resolution technique that facilitates the resolution of systemically important institutions. This was a main recommendation of the 2015 assessment of Key Attributes for Effective Resolution of Financial Institutions conducted by the Financial Stability Board (FSB) with support from the International Monetary Fund (IMF) and the World Bank Group (WBG). Finally, in line with recommendations of the 2012 FSAP assessment of compliance with international standards for deposit

[2] It is important to notice that Colombia reports as NPLs loans past-due 30 days, a stricter criteria that the standard 90 days.

insurers, the authorities have calculated the financial resources needed to meet potential obligations that could arise from financial sector instability and have formulated a strategy to obtain the necessary resources. The proposed operation facilitates access to such resources for bank resolution and is a key element to support the authorities' financial safety net agenda.

Relationship to CPF

7. **The proposed operation is well aligned with the strategic objectives of the WBG's Country Partnership Framework (CPF) for Colombia for Fiscal Years 2016-2021.** The CPF supports three pillars: i) fostering balanced territorial development; ii) enhancing social inclusion and mobility through improved service delivery; and iii) supporting fiscal sustainability and productivity. The proposed operation was contemplated in the CPF and directly supports the third pillar, as it helps the government to improve its management of fiscal risks that may arise from financial instability by facilitating access to liquidity for the deposit insurance fund. Moreover, it also supports productivity growth, as having a sufficiently funded resolution entity facilitate prompt resolution of failed financial institutions and mitigates the effects of a financial crisis on the provision of credit. Finally, the operation also supports social inclusion by protecting the savings of the general population.

C. Proposed Development Objective(s)

8. The project development objective is to strengthen the financial safety net and manage fiscal contingencies by facilitating access to liquidity for the Colombian Deposit Insurance Agency in the event of a systemic financial crisis.

D. Concept Description

9. **Under the proposed operation, the International Bank for Reconstruction and Development (IBRD) and the Multilateral Investment Guarantee Agency (MIGA) would provide guarantees to facilitate the Colombian Deposit Insurance Agency´s (FOGAFIN) access to contingent liquidity funds (CLF).** FOGAFIN – which in addition to paying insured depositors in the event of liquidation is also a resolution fund – currently holds over USD 5 billion in reserves, equivalent to about 4 percent of total deposits. However, to ensure that the fund has resources to face all but the most severe financial crisis, FOGAFIN estimates that it needs its total resources to cover between 4.9 - 6.3 percent of total deposits. To bridge this gap, FOGAFIN is seeking access to a CLF from international banks that could be made available for 5-10 years, with a repayment profile once drawn of a further 5-10 years. The WBG Guarantees will allow access to such contingent lines which FOGAFIN could not obtain without these credit enhancements, given the long commitment term and the likely deterioration of the sovereign rating at the time of the drawdown of the facility. The size, drawdown and repayment profiles as well as the interaction of the two tranches guaranteed separately by IBRD and MIGA will be determined prior to Decision Meeting, following initial market feedback. The facility will be triggered only after FOGAFIN has already used most of its reserves. During the life of the facility, FOGAFIN would undertake further work to determine the optimal structure across pre-funded and contingent resources, as well as explore options for premium adjustments to ensure a stable relation between both sources of resources. FOGAFIN also will explore obtaining an international credit rating for itself, with a view to raising funding from international and local investors in the future as a standalone entity, without any guarantee support from the government or any multilateral development bank.

10. **The WBG Guarantees would be provided by MIGA under the non-honoring of sovereign financial obligations (NHSFO) product and by IBRD under OP 10.00 Investment Project Financing.** The current IBRD resources allocated to this operation in the agreed financial programing

between the Colombian authorities and IBRD amount to USD 120 million, which may support up to USD 500 million of notional principal amount. MIGA would guarantee up to 95 percent of up to USD 800 million of the notional principal amount and 95 percent of the corresponding interest. The team will aim to maximize the crowding in of commercial resources with the minimal use of WBG exposure. While the final split between IBRD and MIGA would depend on the above described circumstances and the final IBRD guarantee coverage on principal required by the market, the MIGA layer would represent a significant portion of the total WBG Guarantees.

11. **The proposed operation supports the authorities' agenda of strengthening the financial sector safety net by facilitating access to contingency funds for FOGAFIN and to help manage contingent liabilities arising from financial sector risks.** The operation supports the authorities' agenda of strengthening the financial safety net, which involves improving financial sector oversight, expanding the tools for the resolution of failed institutions, and ensuring that FOGAFIN has adequate reserves to address financial crises. Sufficient resources at FOGAFIN will help managing fiscal contingent risks arising from financial sector instability. This operation complements the technical assistance and advisory services that IBRD has provided to the Colombian financial authorities to strengthen supervision and bank resolution.

SAFEGUARDS

A. Project location and salient physical characteristics relevant to the safeguard analysis (if known)

12. The Project has no environmental aspects that should be considered; it is established that it will not have any significant environmental impact. Therefore, the team recommends that the environmental category be C. No further actions are necessary.

13. The project does not cause impacts on the territory, neither on ethnic groups, indigenous or Afros, nor on vulnerable groups. In addition, the Project does not require the acquisition of land or buildings. Therefore, it is not recommended to trigger any of the social safeguards (OP 4.10 and OP 4.12)

B. Borrower's Institutional Capacity for Safeguard Policies

14. The objectives and / or components of the Projects do not have environmental aspects that need to be considered. No social or territorial impacts to be considered are identified.

C. Environmental and Social Safeguards Specialists on the Team

Carlos Vargas Bejarano, Carlos Alberto Molina Prieto

D. Policies that might apply

Safeguard Policies	Triggered?	Explanation (Optional)
Environmental Assessment OP/BP 4.01	No	The Project is not expected to have environmental impact. Consequently, the Project's Environmental Assessment Category is rated as Category C. No further actions are required.

Natural Habitats OP/BP 4.04	No	The Natural Habitats policy is not triggered since the Project will not finance activities in these areas.
Forests OP/BP 4.36	No	The Forest policy is not triggered as the Project will not finance any activity that could affect the health and quality of forests, the rights and welfare of the people that depend on them, or changes in their management or utilization.
Pest Management OP 4.09	No	This policy is not triggered. The Project will not finance any activity in the agriculture sector. Also, it will not procure pesticides or lead to increase its use.
Physical Cultural Resources OP/BP 4.11	No	This policy is not triggered. The Project will not finance any activity that could affect physical cultural resources.
Indigenous Peoples OP/BP 4.10	No	This policy is not triggered. The project does not cause impacts on the territory; neither on ethnic groups, indigenous or Afros, nor on vulnerable groups.
Involuntary Resettlement OP/BP 4.12	No	This policy is not triggered. The project does not require the acquisition of land or buildings.
Safety of Dams OP/BP 4.37	No	N/A
Projects on International Waterways OP/BP 7.50	No	N/A
Projects in Disputed Areas OP/BP 7.60	No	N/A

E. Safeguard Preparation Plan

Tentative target date for preparing the Appraisal Stage PID/ISDS

June 30, 2017

Time frame for launching and completing the safeguard-related studies that may be needed. The specific studies and their timing should be specified in the Appraisal Stage PID/ISDS

Category C Project. No further actions are required.

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APPROVAL

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