IMPACT OF THE INTERNATIONAL FINANCIAL CRISIS ON THE COLOMBIAN FINANCIAL SYSTEM AND ITS REGULATION

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Foreword

The Colombian securities self regulatory organization (Autorregulador del Mercado de Valores de Colombia (AMV)) is pleased to introduce the document “Impact of the International Financial Crisis on the Colombian Financial System and its Regulation”. Being aware of the relevance of this subject, our purpose is to offer an independent and objective analysis regarding the origin of and the lessons learned from the crisis, making emphasis on the regulatory recommendations derived from it and the appropriateness of such recommendations for Colombia.

After the outbreak of the crisis in September last year, the first efforts undertaken by authorities of developed countries focused on rebuilding the confidence and soundness of their respective financial systems, as determinant elements for the effective performance of their economies. A great deal of their efforts was also addressed to reduce the impact of the financial crisis on the real sector. By mid-March this year, a number of analytical studies launched more detailed recommendations as to the required adjustment of the regulatory framework, which resulted in the disclosure of the draft financial reform put forward by the government of the United States.

Since last year, at the request of the AMV’s Board of Directors, the executive management of the self-regulatory organization has been following-up the unfold of the crisis. Based on the main proposals disseminated at the end of the first quarter of 2009, AMV undertook the task of elaborating an analytical document on the international financial crisis. The basic concern was to understand the facts that gave rise to the crisis and to assess the appropriateness of the financial policy recommendations for the Colombian case. The importance of this work was magnified by the fact that Colombian lawmakers had undertaken - several months before the outbreak of the crisis - the discussion of a bill introduced by the government in February 2008 regarding a financial reform.

We underline the main conclusion of our study: the impact of the crisis on the Colombian financial system has been marginal. The financial sector continues to be strong and sound despite the fact that the worst collateral effects of the crisis are probably over. The reason is, to a great extent, the existence of a very rigorous regulatory system that has been progressively consolidated as a result of the lessons learned from the mortgage crisis underwent by Colombia in the late 1990s. In this regard, it is worth mentioning the work conducted by several governments and lawmakers that gave rise to Laws 510 and 546 of 1999, 795 of 2003 and 964 of 2005, and their respective regulations.

It is also worth acknowledging the appropriate measures taken by the authorities. On the one hand, since April 2006, the Central Bank undertook the task of controlling the strong growth during the expansion phase of our economy. On the other hand, the Financial Superintendency (Financial Commission) enacted comprehensive regulations regarding risk management systems and, since year 2007, instructed banks and other lending institutions to apply countercyclical provisions.

Our analysis also highlights that the recent financial reform that went through the Colombian Congress granted new powers to the authorities in order to handle crisis situations. We do not share critics made in the sense that it was a missed opportunity for a more structural reform. In this regard it is worth mentioning that in the United States, the country most badly affected by the crisis, the government took several months to put forward a regulatory reform. We agree that structural modifications of aspects relating financial institutions are a task that calls for deep analysis and reflection. For this reason, a structural reform should only be discussed as a result of a critical situation, which fortunately is not the case in Colombia.

This, regardless of the fact that we consider that there are issues that should be given a further thought and that are worth being considered by the authorities. In this study we mention that issues such as taking deposits by unlawful entities, soliciting financial services, providing services through correspondent agreements, consolidated oversight of conglomerates and independence of the regulator, among others, should be discussed in order to strengthen the regulatory system.
We are aware of the fact that this is not a definitive end product given the strong dynamics of financial and economic activities. Notwithstanding, we believe that this may be a useful study for authorities, academic community, journalists, industry and the general public. We believe that, with this study we have fulfilled the purpose of adding elements to the discussion of public policies through analytical and documented proposals.

Finally, I thank AMV researchers that worked on the elaboration of this document, which demanded many hours of stimulating and rich discussions. In particular, I highlight the contribution made by the group coordinated by Felipe Gaviria and integrated by Felipe Rincón, Carlos Adolfo Guzmán, Néstor Camilo Martínez, Ana María Prieto, Angela María Velásquez and María Stella Larios. Though the basic aspects of this work were discussed with the AMV’s Board of Directors, its content does not necessarily reflect the position of its members.

Carlos Alberto Sandoval
President

Autorregulador del Mercado de Valores de Colombia – AMV
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1. Introduction

1. The world financial system has been experiencing deep transformations and adjustments as a result of the biggest financial crisis since the great depression of early 1930s. On the one hand, it can be observed the disappearance and the nationalization of traditional financial institutions of the developed world. On the other hand, many principles of modern financial regulation have been challenged, such as mark-to-market rules, the use of risk rating for prudential purposes, procyclical capital requirements under Basel standards and the need of greater macroprudential oversight, among others.

2. The crisis has no unique cause but rather was spawned by the combination of a number of regulatory and economic factors. Indeed, liquidity excess and macroeconomic imbalances observed in a number of developed economies, together with important financial failures derived from an inadequate regulatory and oversight framework vis-à-vis the challenges of financial innovation and development, are the main causes of the crisis.

3. Four fundamental factors of the global financial system structure can be identified as crisis magnifiers or accelerators: First, inadequate risk assessment and internal control standards. Second, the development of complex financial instruments, rated as highly safe, through which the credit risk was converted into market risk, increasing the contagion and procyclical effect of prudential and pricing regulations. Third, failures in the checks and balances of corporate governance systems of financial institutions. Lastly, the failure of a regulatory and oversight action to promptly detect and contain problems.

4. The bankruptcy of major institutions, such as Lehman Brothers and Northern Rock, and the nationalization and government intervention of others, such as AIG, Citibank, Royal Bank of Scotland, Fannie Mae and Freddie Mac, among others, undermined market confidence.

5. The financial crisis also brought to the attention of the authorities the existence of fraudulent investment systems. During the liquidity boom and deregulation that took place prior to the crisis, a number of frauds became of systemic importance. When investors demanded their funds back to overcome the problem of market illiquidity, such systems collapsed. Additionally, the turbulent juncture opened the path for new types of financial frauds where the target was people seeking to recover their losses. The bankruptcy of the former and the recurrent appearance of the latter further deepened the negative effects of the crisis due to the impact on investment confidence.

6. Based on the foregoing, the crisis expanded to several countries in an accelerated manner and the economic consequences were felt all over the world due to the increasing global interconnection.

7. A number of international financial regulation proposals were put forward between February and June 2009. This document examines mainly those presented by the European Union (Jacques de Larosière report), the FSA of the United Kingdom and the U.S Department of the Treasury. Though many of the recommendations refer to the difficulties brought by the existence of “shadow-banking systems” in developed markets, some of the discussions are relevant for emerging economies like Colombia. Indeed, many proposals are useful to enhance our regulation and oversight standards.

8. Though the Colombian economy has been facing the uncertainty associated with the international crisis, the financial contagion has been marginal. The financial sector has shown sound performance while there is a good prospective for investments pricing and low exposure to toxic assets. It is worthwhile, however, to review other regulation and oversight practices in order to assess whether or not the current regulation is robust enough to convey confidence on the financial sector. This document examines aspects that can be directly
linked to the financial crisis and, also, issues that can be problematic from the domestic perspective. There is also an analysis of the elements required for improving investors’ protection and financial stability.

9. The financial crisis, its macroeconomic origin, the speed and depth of contagion, the regulatory structure, the oversight methodologies, the internal control standards, the risk assessment and other elements, are part of a complex system of interactions.

10. This study examines some of the above-mentioned issues recognizing that it is impossible to deal with all of them. Therefore, the analysis focuses on those that are more relevant for the Colombian case. The problem is approached with the elements known today, however, it is necessary to take into account that solutions and recommendations correspond to a dynamic process.

The document is organized as follows:

11. Chapter 2 describes the international financial crisis. Chapter 3 sets out the degree of direct and indirect contagion of the Colombian financial system. Chapter 4 focuses on those elements that show greater vulnerability for the appropriate functioning of the domestic financial system and its regulatory structure. Chapter 5 analyzes elements necessary for enhancing the regulation of the Colombian financial system structure, differentiating between factors that are subject to changes and those that are not. Chapter 6 contains the conclusions.

12. The Annex summarizes the main recommendations at international level together with the status of the Colombian regulatory system.
2. The International Financial Crisis

a. The housing market and the subprime debt in the United States

13. The recent international financial crisis has its origins in the early 2000s when the American economy began its recovery process in the aftermath of the dot.com crisis of 2000 and 2001. The American government stimulated economic growth through more household consumption (Pérez Saiz, December 2007) and reactivated the housing market through: interest rate reductions by the Federal Reserve, implementation of the “American Dream” policy, granting tax incentives and exemptions for house owners and granting credit facilities for house purchases, among others (Blundell-Wignall, Atkinson, & Lee, 2008)

14. Improvement of economic agent’s expectations translated into an increase of the demand for real property, an increase in house prices and the proliferation of non-conventional financial instruments (Leamer, 2007). Thus, financial institutions increased the borrowing capacity of poor credit rating borrowers, transferring the credit risk to financial markets (Wehinger, 2008).

15. The outcome was a credit risk underestimation. The mortgage lending standards lowered, in many cases driven by the public polices mentioned above, and this resulted in an increase of indebtedness and a mayor likelihood of default. These facts were not taken into account by the risk assessment models of financial institutions.

16. This situation developed in a context of financial innovation which ended up stimulating the proliferation of mortgage loans and instruments collateralized by mortgage loans of poor credit rating denominated as Alt-A debt or subprime.

17. Following a decade of American business cycle expansion, the increase of oil, food and, in general, commodity prices, prompted the increase of interest rates to 5.25% by the Federal Reserve (FED). As the debt servicing grew, the consumption capacity of economic agents deteriorate and the cost of capital increased.

18. Therefore, in 2007 housing prices suffered an average monthly reduction of 0.45%1 and financing costs rose in proportion to the FED’s interest rate adjustment.

19. The procyclical rectification of credit risk ratings of mortgage-backed securities prompted the unwinding of risk positions and the search for less volatile and safer instruments. The reliance on rating agencies to assess assets safety replaced the due diligence and the criteria of professional investors, accelerating the spread of the financial crisis.

20. Investors’ anxiety encouraged an assets sell-off, making difficult the pricing of those assets (Baena, September 2008). This event, also procyclical, entailed a review of the standards on the mark-to-market rules.

21. Therefore, the so-called subprime crisis was a systemic risk phenomenon originated in the American mortgage sector, that later moved towards the global financial markets through complex financial instruments created during the global economic expansion.

22. Regarding prudential regulations, major developed economies follow the principles of Basel I and Basel II for capital requirements, having procyclical effects. During boom periods there is expansion of the credit activity and risk taking is stimulated; whereas during downturns, credit is restricted in order to keep the solvency margins constant. Further, deterioration in loan portfolios may prompt the need for fresh capital when funds become scarce.

1 Average monthly change in year 2007 from House Price Index calculated by the Federal Housing Finance Agency.
23. Internal control practices did not include qualitative aspects, and managers’ criterion was replaced with in-house sophisticated risk models, which results proved to be over-optimistic. The top management approved the use of such models without fully understand them. The non-inclusion of managers’ qualitative criteria gave way to excessive risk taking in products which risk exposure was not properly assessed.

24. Further, checks and balances in the financial institutions’ corporate governance systems failed. The Board of Directors disregarded the functioning of risk models and the characteristics of innovative financial products, and the lack of information regarding the stress scenarios thereof derived in the non-existence of necessary controls. Additionally, managers’ remuneration was based on very short-term goals that stimulated risk taking.

b. Liquidity in Financial Markets

25. An important element for analyzing the financial crisis is market liquidity. In order to study its evolution, we follow the methodology of ex-post liquidity measurement (Baena, September 2008) and the size of bonds market and bonds issuances (Jeanneau & Tovar, June 2008).

26. Prior to the crisis outbreak, low interest rates in the financial markets and the enlarged demand for new financial sources gave rise to an increase of debt issuance levels and trading volumes in the financial markets (Perez Saiz, Diciembre de 2007).


28. It is worth pointing out that since 2005 volumes traded are explained by economic growth and lower inflation rate expectations across world economies (Hördahl & MacGuire, June 2007).

29. According to BIS figures, the OTC derivative market grew 61.78% between 2006 (US$785.000 millions) and 2008 (US$1.27 billions). This growth is explained by an increase in the demand for hedge mechanisms vis-à-vis the increase in the volatility of interest rates and exchange rates during the second half of 2007 and the beginning of 2008.

30. A second element, that characterizes high liquidity levels in the world financial markets, is the increase in placement of debt during 2006 and 2007. In Brazil, China, Colombia, Germany, Japan, Mexico, United Kingdom and the United States, private debt issuance amounted to US$86.966 millions and public debt issuance to US$69.617 millions, with a growth of 10% and 6.78%, respectively.

31. The placement of external public debt increased during the last three years. During 2006 and 2008, the average growth of debt issuance in developed countries was 20%, while in developing countries and Latin America it was 10% and 2%, respectively.
In conclusion, during the period before the financial crisis in mid-2007, markets showed increasing levels of liquidity derived from lower financial interest rates and encouraging economic growth expectations. This was reflected in increasing public and private debt issuance and in larger traded volumes in standardized and OTC markets.

c. The Crisis and Financial Innovation

The financial innovation magnified and accelerated the negative consequences of the international crisis. Since mid-1990s, innovative financial instruments in the United States turned mortgages into speculative and investment financial assets.

While those instruments provided the opportunity for asset diversification and profits, they also encouraged excessive risk taking in the whole financial system as those instruments thrived without any regulatory action and oversight from authorities.

Perception that the growth in value of securitized assets following the originate to distribute model was sustainable in the long-run, led institutional investors to seek larger profits through more complex and sophisticated financial instruments which risks were underestimated. Further, the due diligence process of funds managers and institutional investors was replaced with risk rating agencies paid by the issuers, which in many cases were also advised by such agencies on how to achieve better ratings.

Complex financial instruments were designed in order to obtain larger returns, in most of the cases through increased leverage. The risks of collateralized debt obligations (CDOs), asset backed commercial papers (ABCPs), credit default swaps (CDSs), option rate securities (ARSs), and hybrid instruments as source of regulatory capital, were not properly assessed.

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For an exhaustive analysis of Collateralized Debt Obligations see (Benmelech & Duglosz, 2009) and (Ashcraft & Schuermann, 2008). The Auctions Rate Securities drew the attention during the crisis for the multimillion payment made by sellers of these financial products to small investors when the former failed to act as market makers of these securities (Second Market, 2008).

With respect to hybrid instruments, many of the preliminary recommendations derived from the crisis highlight the importance that regulatory capital, mainly in Tier 1, only incorporates equity and reserves, questioning the Sydney Declaration of the Basel Committee (recommendation 2 of the European Union High Level Group on Financial Supervision).
and largely explain the rapid acceleration and expansion of the crisis. The opacity of these
instruments made difficult the risk assessment and the high quality capital requirements of
financial institutions to back those instruments in many cases proved to be insufficient.

37. Traditional securitizations should not necessarily be associated as the cause of the recent
crisis and should be treated differently. Those instruments have existed for more than 40
years providing large benefits for the market. The main difference between traditional
securitizations and CDOs of last decade is the existence of financial intermediaries that
underestimated the risks at each stage of the process.

38. Loan originators approved disbursements, knowing beforehand that they were going to
distribute such loan and, therefore, origination standards were low. In addition, managers of
trust funds bought those loans (by means of a true sale) and split them into classes
(tranches) for distribution to final investors, using as reference, models of expected losses
that ended being very optimistic. On the other hand, risk rating agencies, involved at
different stages of the process, rated the securitization structure and the respective tranches,
stressing the models used by investment bankers with information corresponding to the crisis
of 2000 and 2001. However, during this period, housing prices rose and foreclosures
corresponded to 1.5% of all US mortgages and, therefore, the stress tests were very low as
compared with what was observed during 2008 and 2009 (Figure 2). Finally, adding credit
guarantees to improve the quality of the respective tranche, through CDSs, or the possibility
of renegotiating interest rates implicit in the securitized loan, made the analysis of security
safety more complex.

39. Moreover, there were securitizations which underlying assets were tranches already
securitized with lower rating (synthetic securitization), which were regrouped and improved
externally through the credit rating, rated and distributed, thus increasing the system
leverage.

40. The allocation of lower capital requirements to the structured products created incentives for
the financial system to invest on them, underestimating the risk and holding a large portion of
the exposure off balance-sheets.

(High Level Group of Financial Supervision in the EU, 2009). However, during crisis the rapid capitalization of the financial
system has proven to be necessary and, for doing this, a number of financial institutions have resorted to hybrid instruments.
With respect to OTC derivatives (mainly credit default swaps) the following problems have been detected: the risk premiums
were not large enough, the secondary market of this kind of instruments exceeded the amount of hedged assets, opacity of
the market prevented proper pricing of this kind of assets and risk exposure. For a deeper analysis see (Criado & van Rixtel,
2008), (Murphy, 2008) and (Dickinson, 2009).

3 The Colombian case is dealt with in Section 3.a.iv.
4 Exposure in banking books was translated to vehicles off balance-sheets by means of actual sales, and then to the treasury
book through purchases of securitized series. Given the low volatility and flattening of reference curves, capital requirements
decreased as a whole, thus increasing the leverage.
41. The crisis unveiled serious shortages in the transparency standards required to properly assess the risks of structured products and other financial innovations. The role of risk rating agencies was crucial. The methodologies used by those agencies, the conflicts of interests and the reliance of professional investors on rating agencies, brought about the underestimation of risk that during the process of downward revision between 2007-2008 resulted in larger losses accounted for portfolio pricing.

42. The recommendations concerning innovative financial products refer to the need of closing information gaps relating those products. This entails information requirements from originators and intermediaries involved in the process of issuing structured products. Part of the transparency requirements is the disclosure of the remuneration systems and, in general, the incentives generated during the process.

43. Those products were developed without appropriate regulation. There was not prudential regulation regarding risk exposure through instruments off balance-sheet. For instance, the distribution of tranches in complex instruments increased the leverage, and financial institutions did not keep during the issuance term a portion of such implicit risk, a fact that was not reflected on the accounting reports. The lack of transparency derived from a deregulation policy prevented oversight bodies from assessing the implicit risk of financial innovations.

d. The Role of Corporate Governance in Financial Institutions

44. There are many lessons to be learnt from recent episodes regarding corporate governance, both as to the way governance bodies of financial institutions are integrated and, as to the scope of their functions. The OECD and the G-20 have undertaken studies on this matter and have given recommendations (Kirkpatrick, 2008).

45. The studies have shown that despite the fact that the board of directors is responsible for defining risk guidelines, no permanent follow-up on compliance existed. On the one hand, the information regarding risk assessment was inadequate, and on the other, such information was not promptly transmitted to the top management for its information, analysis and decision-making.
46. Such studies also concluded that the board of directors’ risk committees comprised members without specific skills on risk management. This situation resulted in a weak analysis capacity on risks associated to the financial institution operation, especially in connection to investments on complex and sophisticated financial products.

47. Situations where the financial institutions’ control and management bodies ignored the required capital and solvency levels and the compliance with such requirements, were eventually detected.

48. The managers’ remuneration and promotion schemes, based on results obtained in securities trading and investment banking activities, encouraged risk taking. In many cases, those schemes were not defined by the board of directors or did not include a robust analysis with respect to the creation of short-term incentives.

49. Based on those findings, the G-20 recommended the strengthening of board of directors with greater participation of independent members experienced in the financial industry and risk management.

50. Another recommendation is the implementation of systems that allow the board of directors to monitor the relationship between risk policies and remuneration policies leading to a balance between risks taken by the financial institution and the prudential policy, the long-term objectives and the dividends for shareholders.

51. Finally, the board of directors should establish standards for determining the risk profile of the financial institution and monitor the compliance thereof.

e. The Role of Risk Rating Agencies

52. All studies on the financial crisis coincide with the responsibility of risk rating agencies in the recent international financial deterioration. Given the complexity of structured products developed as a result of the model originate to distribute, investors relied on risk rating agencies for the risk assessment on assets to be purchased. Professional investors, seeking high returns as offered by structured products, made large investments in assets considered safe, under the impression that the risks they were taking had been properly assessed by such agencies.

53. The replacement of investors’ due diligence with risk rating agencies brought about the underestimation of risks. On the one hand, the models used by those agencies did not include as part of their assumptions, a possible decline of housing prices in the USA (such scenario did not occur for more than thirty years) and, generally, a downturn of economic activities. On the other hand, there was not enough information about the limitations of those ratings and the assumptions the ratings were based on, so that investors could internally validate the assets quality.

54. Underestimation of the likelihood of default of securitized instruments and the subsequent ratings downgrading made evident the methodological and technical difficulties of the rating process. In fact, the insufficient historic information resulted in underestimation of correlations in the default probabilities in relation to changes in economic conditions. Also, the lower standards of mortgage origination were not taken into consideration when estimating the

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5 Initially, rating agencies considered that larger returns were associated to a liquidity premium.
risks of securitized assets, even when the authorities warned the existence of such condition ⁶.

55. Additionally, since risk rating agencies often provided both risk rating and advising services, the originators of complex securitizations knew during the structuring process the minimum quantity of collateral required to reach AAA ratings for tranches of higher hierarchy (Benmelech & Duglosz, 2009). The mistakes of quantitative models made available to issuers ⁷ were replicated in trillions of dollars-worth of securitizations structured using those models. This relationship exacerbated the conflicts of interests spawned by the income structure of those agencies, where issuers pay for the risk rating services.

56. Recommendations regarding weaknesses evidenced in the rating processes follow three axes: i) The first is addressed to users of ratings, mainly institutional investors, indicating that the rating is just an aid for investment decisions but does not replace the need of having appropriate internal proceedings to assess the quality of assets comprised in the portfolio. ii) To raise the stress testing standards and to increase the transparency regarding the methodologies, making available to investors the numeric models so that they could run their own stress scenarios, and also to provide more information on the assumptions made for and the scope of the rating process. iii) To improve the structure of corporate governance of risk rating agencies and, in particular, the handling of conflicts of interests ⁸.

f. The Excessive Volatility of Financial Asset Prices

57. Though the first consequences of the current global economic crisis began to be known in June 2007 (with rumors that two of the main investment funds of Bearn Sterns were suffering big losses derived from large investments on mortgage securities), the highest levels of volatility were recorded in October 2008.

Figure 3
Index VIX Evolution

Source: Bloomberg, AVM calculations.

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⁷ (Standard and Poor’s, 2006).
⁸ Role of rating agencies in the market of structured products (International Organization of Securities Commissions, 2009) and (Committee of European Securities Regulators, May 2008).
58. At this time, all world stock markets suffered a generalized crash with important falls such as: Spain (-9.14%), Paris (-7.7%), Milan (-6.5%), Frankfort (-7%), New York (-4%) and London (-8%). Other stock markets such as Moscow and Vienna closed their operations because of the generalized panic. The Latin American stock markets followed the world trend registering falls of -8.68% in Colombia, -5.92% in Brazil and -3.15% in Mexico.

59. Distrust, uncertainty and nervousness were generalized in the market. Indices such as VIX\(^9\) (Figure 3), that by August 2007 merely exceeded 20 points, rose to a level close to 35 points in September 2008 and to a maximum of 82 points in October of the same year. In this period the effects of the crisis were reflected in the value of the market capitalization of listed companies, and all world stock market indices tumbled.

60. Different economic developments that badly affected major financial institutions such as *Lehman Brothers*, *Merrill Lynch*, *Northern Rock* and *AIG*, among others, weakened the main world economies and resulted in the high volatility observed in the VIX index, which also affected highly correlated markets such as the bond markets, the stock markets, the commodity markets and the foreign exchange markets worldwide. (See Figure 4, Figure 5, Figure 6, Figure 7).

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* Daily volatilities calculated using the methodology of exponential smoothing EWMA with a Lambda standard of 94%.

\(^9\) The VIX index is an indicator of the implied volatility of S&P 500 index options.
Volatilities of the bond markets and the stock markets rose to unprecedented levels of 4% and 3% respectively due to the economic panic generated by the international crisis during the second half of 2008. Foreign exchange markets and commodity markets showed a similar behavior during the same period, with daily volatilities of 3.5% and 8% respectively.

Shortcomings of the Regulatory Structure

A number of analysts have stressed the fact that one of the main factors that triggered the financial crisis was the regulation applicable to the financial and securities markets.

Undoubtedly the United States has developed the most deep, sophisticated and efficient capital market of the world. It has also one of the oldest (established in 1934) and more complex regulatory and supervisory models in the world, with coordination failures that became evident with the crisis.

On June 17th the U.S. Department of the Treasury published a document setting forth guidelines for the reform of the regulation and oversight structure of the U.S. financial system. The reform seeks enhancing the coordination mechanisms among agencies, monitoring all financial institutions - including non-bank institutions - that embodied systemic risks, introducing better prudential standards, increasing transparency as a mechanism to improve market discipline, providing better protection for financial consumers and strengthening international cooperation.

Today, the regulation and oversight system of the U.S. capital markets is made up of the following:

- Regulators and supervisors at federal level:
  - Federal Reserve (Fed),
  - Office of the Comptroller of the Currency (OCC),
  - Office of Thrift Supervision (OTS),
  - Federal Deposit Insurance Corporation (FDIC),
  - National Credit Unions Association (NCUA)

- More than 50 banking supervisors at state level.

- The securities markets has a federal regulator and overseer called Securities and Exchange Commission (SEC), and two types of self-regulatory organizations (i) an independent self-

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The table below shows the kind of financial institution and their corresponding regulators and supervisors.

<table>
<thead>
<tr>
<th>No.</th>
<th>Institution</th>
<th>Regulators</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>National Banks</td>
<td>OCC, Fed, FDIC, SEC</td>
</tr>
<tr>
<td>2</td>
<td>State bank members</td>
<td>Fed, state regulator, FDIC, OCC, SEC</td>
</tr>
<tr>
<td>3</td>
<td>Non-member state banks but affiliated to FDIC</td>
<td>FDIC, state regulator, OCC, Fed, SEC</td>
</tr>
<tr>
<td>4</td>
<td>Federal Saving Associations</td>
<td>OTS, FDIC, OCC, Fed, SEC</td>
</tr>
<tr>
<td>5</td>
<td>State Saving Associations</td>
<td>OTS, state regulator, FDIC, OCC, Fed, SEC</td>
</tr>
<tr>
<td>6</td>
<td>Non-FDIC affiliated state banks</td>
<td>State regulator, OCC, Fed, SEC</td>
</tr>
<tr>
<td>7</td>
<td>Non-FDIC affiliated Federal Saving Associations</td>
<td>State regulator, OCC, Fed, SEC</td>
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<tr>
<td>8</td>
<td>Federal Credit Associations</td>
<td>NCUA, OCC, Fed, SEC</td>
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<tr>
<td>9</td>
<td>Non-FDIC affiliated State Credit Associations</td>
<td>NCUA, state regulator, OCC, Fed, SEC</td>
</tr>
<tr>
<td>10</td>
<td>Holding Banks</td>
<td>Fed, state regulator, OCC, SEC, state regulator of insurance</td>
</tr>
<tr>
<td>11</td>
<td>Financial Holdings</td>
<td>Fed, state regulator, OCC, SEC, state regulator of insurance</td>
</tr>
<tr>
<td>12</td>
<td>Saving Corporations</td>
<td>OTS, state regulator, SEC, state regulator of insurance</td>
</tr>
</tbody>
</table>

Source: (Malloy, 2006)
regulator for all securities firms and trading systems (*Financial Industry Regulatory Authority – FINRA*)\(^{11}\) and (ii) all stock markets and trading systems with self-regulatory functions with respect to their systems, such as the NYSE, Nasdaq (its self-regulatory functions have been outsourced to FINRA), and the American Stock Exchange, among others. There are also more than 50 regulators and overseers at state level.

- Futures and options market has a regulator and an overseer at federal level called *Commodity Futures Trading Commission* (CFTC), without prejudice of regulators and overseers at state level. For this market, there also exists an independent self-regulator for the U.S. futures industry, and the self-regulatory functions of markets and trading systems mainly concentrated on the Chicago Mercantile Exchange Group Market Regulation.

66. This institutional and functional regulatory and oversight structure - developed since the great depression - has many problems. The large number of competing jurisdictions, the existence of cross responsibilities, difficulties in coordination, confusions among oversight bodies and excessive costs, encouraged a regulatory competition that ended up with lower regulation standards (U.S Department of Treasury, 2009)

67. There is no overseer with jurisdiction over consolidated financial groups. Therefore, there is no oversight body with the appropriate tools to adopt measures needed to mitigate systemic risks. This limitation has been evident since 2006 when public discussions hinted that the market was incurring in excessive risks on mortgage portfolios. There was no accurate diagnostic regarding the risks and, it was mistakenly assumed that the risks were spread globally among those with capacity for bearing such risks (Ackerman, 2009).

68. Another difficulty is that insurance institutions escape to federal regulation and oversight. This task is the responsibility of regulatory bodies at state level.

69. Institutions created by lawmakers to foster housing, such as Fannie Mae and Freddie Mac, were oversight by the Federal Housing Finance Agency. Given its nature, this governmental body did not have experience or specialized knowledge for overseeing capital markets.

70. Regarding the regulation and oversight of investment banks, with the enactment of the Gramm-Leach-Bliley Act of 1999, the United States Congress resolved that this type of institutions would not be subject to prudential oversight by the State\(^{12}\). This deregulation policy is supported by the idea that wealthy investors and securities markets experts should not be subject to state regulation, given the fact that they have the means and necessary resources to assess the risks they can take (Greenspan, 2009). It was considered that investment banks were able to self-impose their own limits without any government or external self-regulatory body intervention\(^{13}\). Under this postulate it was justified the absence of regulation on Hedge Funds, which are characterized by their high leverage and risk levels.

71. The current regulatory structure of the United States’ capital market is unique. There is no other country with similar level of development having such degree of complexity and deregulation.

72. The crisis has prompted a reform of the capital market regulatory and oversight structure in the United States. The main objective will be the adequate oversight and risk assessment over the system. A number of initiatives in that direction have been put forward by academia, including: the need to regulate and to oversee investment banks, settlement systems, and hedge funds, as well as the need to enhance the coordination among authorities and, if

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\(^{11}\) FINRA is the result of two self-regulators merger: Nasdaq and the NYSE regulatory services area

\(^{12}\) Since 1994 the United States promoted the use of self-regulation by financial institutions regarding the ability to take risks of prudential nature (Gapper, 1994).

\(^{13}\) See section 2.h.
possible, creating a system that eliminates duplicities and with macroprudential power. (The Department of Treasury of the United States, 2008).

73. The draft reform put forward by the U.S Treasury in June 2009 entailed the creation of a banking supervisory body at national level with the merger of OCC and OTS into a single body. The FED would have the responsibility of broadly overseeing financial institutions with systemic importance, regardless of their legal form; this implies that institutions other than commercial banks would be under the FED jurisdiction. The creation of the Council of Financial Regulators has also been suggested in order to implement a supervisory macroprudential approach. All financial institutions, regardless of their legal form, including hedge funds, would be subject to oversight and minimum capital standards.

74. In Europe regulatory and supervisory models are different. In the United Kingdom, more than ten years ago, the regulatory system underwent a structural review, and a system of macroprudential oversight was created based on three bodies fully coordinated: the Bank of England, the National Treasury and the Financial Services Authority (FSA). Each body has its own and complementary role.

75. However, the United Kingdom did not escape to the crisis, despite the fact that its regulatory and supervisory system differs from the United States’. The credit boom and the cycle of housing prices were similar to the United States’, which led to a rapid growth of some banks that were short-term funded and dependent on global securities markets to unload their credit risk exposure derived from mortgage portfolio origins. With the loss of liquidity in the global markets, funding possibilities declined and the subsequent asset liquidations led to mark-to-market losses and to the bankruptcy of Northern Rock, Bradford & Bingley and HBOS.

76. In Continental Europe the regulatory failures became evident, mainly because of the lack of consistency in the enforcement of regulations and the lack of coordination among European Union countries (The High Level Group of Financial Supervision in the EU, 2009). For example, in The Netherlands, which has a twin peaks regulatory structure, the banking system suffered significant contagion; in Island a number of banks went broken. Like in the United Kingdom, most European banks have undergone difficulties as their market risk transformed into liquidity risk triggering losses on mark-to-market losses.

h. The Self-regulation Concept in the Financial Crisis

77. The financial crisis has given rise to considerable criticism of financial market self-regulation. For the sake of discussion, it is important to have clarity on the meaning of self-regulation as well as of the different nuances.

78. Self-regulation is the self-imposition of rules in any matter. In the financial system the scope of self-regulation is broader in view of the implicit role of the State in market regulation. Indeed, to greater involvement of the State as the system regulator, the lesser room for self-regulation.

79. Self-regulation in the financial system can be in different forms. For the purposes of this chapter, we defined four categories: i) “pure” or “voluntary”; ii) “regulated”; iii) “independent” or “endogen”; iv) “external”.

80. “Pure” or “voluntary” self-regulation occurs when a number of private parties make a conscious and voluntary decision of establishing the rules for a particular activity or operation. Under this system, the group develops rules without the involvement of the State.

14 See chronicles of DNB’s credit crisis (De Nederlandsche Bank, 2009)
81. "Regulated" self-regulation occurs when the State is involved in laying out the parameters for the development of rules, oversight and discipline, and/or overseeing the process (Rosillo Rojas, 2008). Self-regulation developed by the Autorregulador del Mercado de Valores de Colombia (AMV) follows this model.

82. "Individual" or "endogen" self-regulation occurs when a single participant in the market self-imposes rules and autonomously exercises its own oversight and discipline. In this model, no third parties are involved, either as self-regulated or self-regulators. In this case, the homogeneity of self-regulation for the industry is non-existent. While under this self-regulation model it is possible that the State requires self-regulation by certain market participants, imposition of constraints has individual character and rules are internally developed by each entity.

83. "External" self-regulation occurs when a body independent from the self-regulated institutions, from the stock exchanges and financial markets and from the State is responsible for self-regulation. This is the case of AMV or the FINRA in the United States, to name a few.

84. A self-regulation model encompasses the features of the four models mentioned above. For instance, the existence of a "regulated-external" self-regulation model is possible. This means that the State imposes self-regulation obligations, with or without minimum parameters, and its enforcement is the responsibility of an external body. The existence of a "regulated-independent" self-regulation model in which the State imposes the obligation to internally develop the regulation for each participant in a particular subject, is also possible.

85. Criticism arising from the crisis refers to the policy of prudential deregulation and "independent" self-regulation developed in the United States since 1994. Indeed, Alan Greenspan, FED chairman, pointed out in 1994 that banks and financial institutions should increasingly depend on "independent" self-regulation, as the State was unable of exercising such function. Greenspan referred to the set of rules independently developed by each financial institution to assess financial risks taken.

86. Under this independent self-regulation policy, there are no adequate mechanisms for handling conflicts of interests, as those who took risks were the same that established the rules for risk-taking. Furthermore, there were a number of measures that encouraged taking greater risk, for instance, remuneration systems tied to the number of mortgages granted.

87. The American deregulation model has been pointed as one of the main causes of the financial crisis. Indeed, Greenspan pointed out that the self-interest of shareholders and managers in financial institutions should lead to the adoption of adequate provisions against insolvency by permanently monitoring capital and risk positions. For long time this approach seemed uncontroversial; however, it failed in the summer of 2007. Today, Greenspan acknowledges that the deregulation model through "individual" self-regulation failed. It is important to highlight that the "external-regulated" self-regulation model, like the FINRA in the United States, has never been criticized.

88. The "external-regulated" self-regulation model is complementary to the State tasks as it provides specialization and raises the standards of self-regulated sectors. To the extent that the body responsible for the enforcement is independent from market participants, it is possible to work out measures leading to prevention as well as to deal with the problem of conflicts of interests. Further, under this model, the self-regulatory body is submitted to oversight by the government and follows the principles and criteria set out by the State. Broadly speaking, this is the model developed by AMV.

16 See: Alan Greenspan. "We need a better cushion against risk". Financial Times, March 26, 2009
Therefore, criticism to self-regulation should not encompass models developed by external bodies that are overseen by the State, such as FINRA or AMV.

### The Episodes of Pyramidal Schemes in the Financial Crisis

Recent financial frauds have damaged a large number of investors, increasing mistrust in the markets on top of the financial crisis. This has triggered criticism regarding the SEC and other authorities' capacity to safeguard the investors' resources.

The pyramids and Ponzi schemes are mechanisms where a single person or company takes money from the general public to seemingly make investments in lucrative businesses. However, unlike real investments, the payment of benefits depends on the money deposited by new participants. The scheme collapses when capital inflows are not enough to pay back withdrawers when their investment comes to maturity\(^\text{17}\).

According to the information available, since 2002 the SEC had instituted actions against 300 people for directly or indirectly operating Ponzi schemes\(^\text{18}\), and in the last two years has filed 75 investigations for the same reason (Walter, 2009). Despite those efforts, unwary investors kept investing on those pyramidal schemes\(^\text{19}\).

The most conspicuous case has been the scam perpetrated by Bernard Madoff, considered as the biggest Ponzi scheme in history, after registering losses of more than US$500 billions. Madoff promised annual returns between 10% and 12% using feeder funds that funneled the money towards a stock portfolio managed by his investment company, Bernard Madoff Investment Securities (BMIS), without having any direct relationship with his customers\(^\text{20}\).

In accordance with the SEC's investigations (SEC Complaint, 2008), the scheme started in the early 1990s in New York and, since then, expanded to a number of countries, offering high returns. His main feeder fund, Fairfield Sentry Ltd (FFS), funneled around US$8 billions from investors domiciled in Switzerland, Madrid, Brazil, and New York. In 5 out of 156 months of operation, the fund reported a negative performance and its volatility was of 2.5%, below the level experienced by the S&P 100 index (14.8%) (Gregoriou & Lhabitant, 2008).

Some journalists and market experts raised doubts about the funds outstanding results and charged Madoff of misbehavior in relation with conflicts of interests and insider trading. Harry Markopolos, the main complainant, since 1999 sent 29 warnings to the SEC, alleging the risks and irregularities of the scheme. The SEC visited Madoff's premises several times but never detected a fraud.

Despite multiple warnings, investors continued investing on Madoff and his feeder funds. In the second half of 2008, in an environment of low liquidity and financial stress, Madoff encountered difficulties in obtaining new resources to match the investors' withdrawals and to keep up the returns offered to them. Between September and October 2008, investors withdrew around US$1 billion from feeder funds and the scheme ended up collapsing in

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\(^{17}\) A mathematical demonstration of pyramids collapse can be seen on: *Semana Económica* 643. Asobancaria. “Pyramids, stronger action is required”. (available on www.asobancaria.com)

\(^{18}\) Carlo Ponzi scammed about 40,000 people between 1919 and 1920, promising return of 50% in 90 days for investing in a fictitious company called Securities Exchange Company that was apparently engaged in postal coupon arbitrages, whereas savings accounts offered 5%. Ponzi was convicted for fraud when it was discovered that the money was not reinvested in such company.

\(^{19}\) Several courts in the United States have concluded that Ponzi schemes, and in general, pyramids, fulfill the Howey Test requirements whereby those should be considered as a value, and therefore the SEC has the responsibility of detecting and disciplining them.

\(^{20}\) Madoff claimed that his investment company administered a portfolio of 100 stocks of the S&P using a conservative strategy called ‘split-strike conversion’. He used 6 feeder funds to raise money but investors were never informed that Madoff’s company managed their money and, thus, he never had the need to disclose detailed information of his operations.
November 2008, when withdrawals reached US$3 billion and Madoff did not have the capital required to pay back (Clauss, Roncalli, & Weisang, 2009).

97. On December 11 2008 Madoff confessed the scam and on March 12 2009 was convicted to 150 years of prison. In April 11 2009, the State of Massachusetts filed a complaint against Fairfield Greenwich Group for failing to comply with its fiduciary duty and for deceiving its customers through the Madoff’s fraudulent scheme.

98. On February 17 2009, the SEC instituted an action against Robert Allen Stanford and some of his closest collaborators for using fraudulent information for taking deposits from the general public, through Deposit Certificates issued by Stanford International Bank (SIB) domiciled in Antigua and traded through the broker Stanford Financial Group Company and the investment advisory firm Stanford Capital Management, both domiciled in Houston. Thereafter, on February 27 2009, the SEC modified its initial charges and claimed that Stanford and his collaborators were operating a Ponzi scheme.

99. According to the investigation, Stanford and his team took deposits for US$8 billions promising rates of interest higher than those offered by certificate deposits from American banks and an investment portfolio diversified, safe and liquid. In fact, the resources were invested on real property and on private debt instruments, and it is estimated that at least US$1.6 billions ended up as Robert Stanford’s personal loans. An undetermined amount was invested on speculative private businesses.

100. In the Stanford’s case, the SEC has found: manipulation of SIB’s accounting, fictitious information handed over to customers, non-disclosure of both true portfolio composition and personal loans. Whereas between 1994 and 2008 traditional stock markets indices like S&P 5000 reported losses close to 39%, SIB reported returns from its portfolio investment larger than 10%, and reported losses for just 1.3% in 2008.

101. That fraud had repercussions on a number of Stanford’s subsidiaries not involved in such affair. In Venezuela and Panama the authorities took control of the subsidiaries. In Colombia, Ecuador and Peru the subsidiaries suspended operations to protect the customers’ interests and to preserve market stability.

102. Madoff and Stanford scandals accelerated the collapse of a number of Ponzi schemes. Between December 2008 and March 2009 the SEC detected 12 scams denominated ”mini-madoffs” with losses close to US$228 millions. The United States authorities deployed efforts aimed at discovering many pyramidal schemes and for bringing to an end the proliferation of this type of scams to securities stock and financial markets. For instance, the CFTC (Commodity Futures Trading Commission) set up a special unit in August 2008 – Forex Enforcement Task Force – in order to detect Ponzi schemes in the Forex market, and the SEC strengthened its oversight and enforcement tasks, reinforcing collaboration channels with the authorities at state level and with whistleblowers.

103. Notwithstanding, the SEC has been criticized for its lack of capacity to end the propagation of those schemes. Some consider that this is explained by budget constrains, lack of experience and training of its staff, conflicts of interests of overseers with the industry and fragmentation of the regulatory structure (Poser, 2009).

104. Indeed, according to the most recent figures available, there has been a strong departure of SEC’s employees. Whereas the number of firms, market vehicles and assets grew significantly between 2005 and 2007, the staff devoted to oversight and enforcement

21 (SEC, 2009), (Simpson, Searcey, & Scannell, 2009) and (Lynch, 2009).
22 (Wayne, 2009), (Stecklow, 2009) and (Chew, 2009).
23 The SEC has prepared a capacity building program to detect Ponzi schemes and other related frauds with courses addressed to researchers and supervisors (Reuters, 2009)
declined 7% and 10% respectively. Today the SEC has 3.600 employees to oversee more than 3.600 financial institutions (stock market brokers, issuers, mutual funds and investment advisory firms) (Schapiro, 2009).

105. It is expected than in 2009 the SEC increases its staff and resources devoted to market surveillance, enforcement and risk analysis. This will help to strengthen its tasks relating investigation charges on frauds and Ponzi schemes. However, for many, the SEC should make an effort for improving its remuneration standards with the aim of attracting qualified people and reducing the turnover.

j. Proposals and Recommendations in the aftermath of the Crisis

106. In response to the failures made evident through the crisis, regulatory reforms have been put forward worldwide. On February 25 2009, the European Commission under the direction of Jacques Larosière submit the first proposal consisting of regulatory reforms on the financial system at the international, European and national level. The multilateral bodies also published for public discussion a series of documents dealing with the crisis; for example, on April 2 2009, the IMF presented a document on the initial lessons learned from the crisis. The same date, a G-20 meeting took place to discuss the challenges of the financial crisis and the result was a commitment to enhance financial regulation and oversight. On March 18, the FSA published an analysis on the origins of the crisis, the regulatory shortcomings and a number of recommendations. More recently, on June 18 2009, the U.S Department of Treasury published a proposal to reform the American regulatory structure. The analysis of recommendations includes the above studies and others from the academia.

107. This chapter reviews some aspects of the reforms put forward; however, it is not an exhaustive analysis of the convenience as to whether or not adopting different alternative policies. We focus on the proposals dealing with the financial and regulatory structure to improve risk assessment, customers' protection and transparency. The analysis addresses five subjects: i) consolidated oversight; ii) macroprudential oversight; iii) risk assessment and microprudential oversight; iv) customers' protection from financial abuses and frauds; and v) other significant regulatory changes. The Annex brings together all the recommendations and a comparison with the current Colombian regulation.

i. Consolidated Oversight

108. In the United States, regulatory gaps and duplications hindered the adoption of actions and later, the assignment of responsibilities. Surveillance of the most important financial institutions - in terms of size and risks for the economy - was in hands of several federal agencies. The fragmentation of responsibilities allowed managers of those financial institutions to switch regulators, giving rise to a “race to the bottom”.

109. In Continental Europe and in the United Kingdom existed a system of shadow banking outside the scope of regulation and oversight. Though the European Directive on Capital Requirements calls for regulation and surveillance of investment banks, off balance-sheet vehicles and autonomous patrimonies of systemic importance were created. Financial instruments with sophisticated legal forms designed to escape regulation – but which role in the financial system and the economy corresponds to supervised entities – made difficult the consolidation process by the authorities.

110. As to recommendations, there is consensus on the fact that prudential regulation of financial institutions should be the responsibility of one regulator encompassing credit institutions, investment banks, asset managers and insurance companies. On this manner, the risk of regulatory arbitrages and inconsistencies are reduced. Additionally, it enables identifying and reducing the existence of financial activities structured in special legal forms – to avoid
oversight – mainly if powers are granted to conduct consolidated surveillance in order to obtain information and to add those vehicles to prudential regulation.

111. Application of the above recommendations differs in each jurisdiction. Given the regulatory fragmentation of the U.S. system, there are political and practical problems for the implementation of one single overseer. The proposal put forward by the Department of the Treasury states that consolidated oversight should be in the hands of the Supervisory Council for Financial Services. All chairmen of federal supervisory agencies, the chairman of the FED, the Secretary of the Treasury and the director of the FDIC, among others, integrate this Council. This Council facilitates the collaboration among different bodies, the compilation of market information, the identification of regulatory failures, and subsequent regulatory proposals of reforms.

112. A far-reaching proposal is to grant powers to both the Council and the FED to submit to prudential regulation and oversight any company that represents a risk for the system stability in view of the size, leverage and interconnection with the financial system, and regardless of its legal nature. Under such criteria, the FED would have the power to request information and to investigate any financial institution in the United States, and may identify any companies that should be subject to consolidated oversight. Companies under the FED oversight would be subject to stricter capital and liquidity requirements to internalize the costs of an eventual bankruptcy.

113. A highly relevant proposal is the FED’s power to examine information relating parent companies and their subsidiaries. The United States authorities came to the conclusion – as a result of the crisis – of the need of having full knowledge of firms and the financial conglomerate those firms belong to.

114. In the European case, where already exists some integrated oversight, the recommendations have important implications with respect to the scope of the rule making process. Granting powers to regulators in order to oversee any person that entails risks for the system stability has been proposed. For instance, hedge funds would be subject to prudential regulation and oversight although those funds were not at the center of the crisis.

ii. Macroprudential Oversight

115. One of the lessons learned from the crisis is the link between the macroeconomic policies, mainly monetary policies, and the regulatory policies of the financial system. The high liquidity led to leveraging and excessive risk-taking through innovative financial instruments that exacerbated the procyclical market asset pricing and prudential capital requirements. A loose monetary policy led to cheap credit that eventually translated into a bubble in asset prices such as real property prices. (Calomiris, 2009).

116. There is no consensus as to how monetary authorities should use the toolkit at their disposal to prevent bubble in asset prices, but the analysis regarding systemic risks should prevent excessive and unsustainable growth in loan placements and system leveraging. Moreover, there should be prudent measures such as countercyclical provisions.

117. Capital requirements that remain constant in time are, per se, procyclical. Defaults during the economic slowdown trigger losses that reduce capital, which in turn reduce the lending activity that leads to further slowdown. If capital requirements are less strict during the trough stage of the economic cycle, there should be larger capital requirements during the expansion stage of the economic cycle. Dynamic provisions loan losses implemented in Spain and Colombia are recognized as necessary alternatives under a prudential countercyclical framework.

118. Prudential regulation seeks safeguarding individual firms and is complementary of other forms of surveillance developed to safeguard the system as a whole. This implies larger and
better quality of capital and countercyclical capital requirements. The foregoing allows strengthening the financial system vis-à-vis shocks of the real economy and mitigating the impact of financial cycles upon the macroeconomic situation of each country.

iii. Risk Assessment and Macroprudential Oversight

119. Risk underestimation, excessive risk-taking through leveraging and lack of high quality capital of firms individually considered, are some of the main causes underlying the crisis. Risk models used by firms proved to be insufficient and the authorities were late in preventing the contagious effects of failing institutions. Safeguarding the stability of institutions entails adequate risk assessment and pricing, and the criterion of overseers to intervene promptly under adequate standards of independence.

120. Financial innovation, specially the model originate to distribute, was encouraged by a demand for greater returns and high liquidity. The belief was that under this model it was possible to reduce banking risks through investors willing to bear those risks and cheapening the intermediation. At the outbreak of the crisis it was made evident that credit risk had not been transferred to investors, but rather had migrated from the banking book to the treasury book, which capital requirement was low during periods of high liquidity and low assets pricing volatility (VaR models). The complexity of products developed was evident, but investors relied on internal mathematical models on risk assessment and supposedly adequate risk rating methodologies developed by risk rating agencies.

121. Risks assessment models developed internally were not understood by the top management and ended up substituting qualitative criterion. Given the fact that those models were based on short-run historical information (one-year) to make inferences on the future, the forecasts proved to be over optimistic. Stress scenarios and risk ratings were also optimistic because of the failure to fully understand the underpinnings of the models, the failure to consider the aspects of an inter-related global financial system and the changes introduced into the traditional intermediation through the model originate to distribute and, also, because of the generalized optimistic perceptions derived from the economic environment.

122. The first overall recommendation is that standards of risk assessment should be improved, reducing their reliance on VaR models and on risk rating agencies. Indeed, the United States reform proposal suggests eliminating from the prudential regulation, to the possible extent, the use of risk ratings. It also suggests increasing the standards of internal control and emphasizes the need that top managers understand and limit the risks bore by financial institutions.

123. The role played by supervisory authorities should complement the initiatives to improve risk assessment and to limit the risk-taking of each company. Had authorities promptly identified companies risk exposure, the effects of the crisis would have not been so severe. Overseers should be equipped with the necessary tools to promptly detect risks, to be able to defend their own risk estimations and to call for higher standards of internal control and capital. Overseers should also be protected against political pressures and influence from the industry, with a clear mandate and enough resources while being liable for their actions before the political authorities.

iv. Protection of Financial Consumers and Investors against Abuses and Fraud

124. The crisis made evident the failure of government agencies to prevent abuses and frauds against financial consumers and investors. Ponzi schemes proliferated, complex and inappropriate products were sold to many investors, loans were placed to debtors that could not afford to pay back, and during the crisis innovative fraudulent mechanisms that took advantage of the investors’ desire to recover their losses, continued to appear.
125. The United States proposes the creation of a specialized agency to protect financial services consumers. The goal is eliminating the existing conflict that supervisors have between ensuring stability of financial institutions and consumers’ protection. Furthermore, the public confidence on the system is crucial for proper functioning thereof. Additionally, the SEC should be given more powers to improve the tools at its disposal to fight against fraudulent schemes.

126. In any case, the creation of agencies for financial consumers’ protection is not applicable to all jurisdictions and such recommendation should not be generalized. Given the level of development of the United States, it was decided that issues related with the protection of banking consumers should be in the hands of an independent agency, and issues related with investors continue to be in the hands of the SEC.

v. Other Regulatory Changes

127. Other recommendations on regulatory changes that deserve analysis are the following: i) risk rating agencies; ii) corporate governance and remuneration practices; iii) derivatives traded over-the-counter.

128. Recommendations regarding shortcomings of risk ratings are threefold: i. Risk rating is just a support of investment decision-making but does not replace the need of having internal processes to assess the quality of financial assets portfolio. This recommendation is addressed to risk rating users, mainly institutional investors. ii. Raising stress testing standards and increasing transparency on methodologies, making available numeric models to investors to run their own stress scenarios. Also, the provision of more information and the scope of assumptions underlying risk ratings. iii. Dealing with the corporate governance structure of rating agencies and, specifically, the manner to handle conflicts of interests.

129. Regarding corporate governance, the G-20 recommended the strengthening of boards of directors with more participation of independent members having experience in both the financial industry and risk management. Any board of directors should oversee the relationship between risk policies and remuneration policies, to achieve a balance among the risks borne by the financial institution, the prudential policy, the long-term goals and the dividends handed over to shareholders. Finally, it has been suggested that boards of directors set up parameters to be taken into account for the determination of the financial institution risk profile and ensure the compliance with such parameters.

130. One of the aspects that have received increasing attention is how OTC derivatives are traded and settled, mainly credit default swaps. Given the OTC character and the market size, systemic risks have been identified, since default by a participant may create a “domino effect” of defaults. There is consensus in the sense that a multilateral netting system through a centralized exchange or clearing house for CDS transactions may reduce this risk. Both Europe and the United States are working to encourage infrastructure suppliers to implement this system.

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24 The role of rating agencies in the market of structured products (International Organization of Securities Commissions, 2009) and (Committee of European Securities Regulators, May 2008).
3. Impact of the Financial Crisis in Colombia

a. Direct Transmission Channel

131. The financial international crisis has badly affected most of the developed economies and some emergent countries. Latin America showed a relative positive behavior during 2008. However, the strong fall of commodity export prices, the deterioration of external demand, the reduction of remittances flow and, in general, the financial contagion, have recently raised the level of vulnerability of the region (World Bank, March 2008) and (BBVA, March 2009). Those events have engendered stress in investors, increasing the risk perceived on the sovereign-debt since the second semester of 2008 (Figure 8).

Figure 8
Embi+, Embi + Colombia and Embi + Latin America

Source: Bloomberg.

132. The trends outlined above have impacted the behavior of the domestic financial system and the financial assets market. This chapter makes an analysis of the financial transmission channels of the crisis into the financial sector of the Colombian economy.

i. Financial Assets Market

133. Stock exchanges are the first transmission channel of the crisis, reflected on stock market indices. Figure 9 shows that from September 2008 when the crisis began to accelerate, the world stock markets experienced generalized falls: Japan 42%, Brazil 41%, Germany 40%, U.S 34%, Colombia 29% and Mexico 24%.

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25 The real transmission channels of the crisis, undoubtedly, have an impact on the behavior of the financial system and deserve a separate analysis.
Figure 9
Evolution of world stock market indices*

![Evolution of world stock market indices graph](image)

*Base 100 = 4 January 2007.
Source: Bloomberg, AVM calculations.

134. The foreign exchange market is another transmission channel. Until mid-2008, the Colombian peso was experiencing a strong appreciation in relation to the U.S dollar. From second semester 2008, the Colombian peso started to depreciate as a result of the uncertainty precipitated by the financial crisis, the impact of slowdown of exports and the reduction in the flow of remittances. (Figure 10).

Figure 10
Foreign exchange rate evolution

![Foreign exchange rate evolution graph](image)

Source: Financial Superintendency of Colombia and Central Bank

135. During 2007 and part of 2008, the domestic public debt market was driven by inflation expectations. For two years in a row, inflation was above the Central Bank target and, in 2008 the inflation rate was 7.67%. Such inflationary pressures began to yield towards the end of that year, especially during 2009, as a result of a fall in energy and raw material prices, thus decreasing the domestic rate of inflation (Banco de la República, 2009). Therefore,
between November 2008 and June 2009, the Central Bank reduced its intervention interest rate by 550 basis points. Such countercyclical monetary policy had an impact on short-term and medium-term interest rates of TES.

136. Notwithstanding, as shown in Figure 11, between September and November 2008, there was an important stress event, spawned by the uncertainty of the international crisis, having an impact on medium-term and long-term benchmarks. Between September 11-17, 2008, the EMBI+Colombia rose 94 basis points (Figure 8), resulting in an increase of more than 60 basis points of the 20 years benchmark interest rate of TES between September 15-19. Likewise, between September 22 and October 22 2008, the EMBI+Colombia rose to more than 480 basis points and, the 20 years benchmark interest rate of TES rose more than 100 basis points.

Figure 11
Yield curve zero coupon TES Col pesos

Source: Bloomberg.

Figure 12
Public Debt Index - Corficolombiana

Source: Corficolombiana.
Since November 2008 the public debt market has favorably behaved. Indeed, between October 24, 2008 and June 26, 2009, TES-2020 appreciation was close to 30%. Such appreciation was generalized for all public debt bonds, as shown by the Public Debt Index calculated by Corficolombiana (Figure 12).

ii. Overview on the Colombian Financial System

The Colombian financial system indices regarding coverage, profitability and solvency are positive and stable. Therefore, mitigation of the crisis effects and continuance of the industry soundness have been possible.

Since mid-2007 the credit market has been experiencing a slowdown and, the loan portfolio has deteriorated. Consumption loans have been harshly hit; according to figures from the SFC SFC, annual growth of consumption loans changed from 32.5% in 2007 to 11.6% in 2008, whereas the quality indicator rose 1.6 basis points. Despite this trend, the coverage index of nonperforming loans remains above 100%.

Volatility increases resulting from the financial crisis have had moderate impact on the investment portfolio and, generally, on the industry balance sheets. The reason is the low share of foreign assets in the investment portfolio. According to the SFC’s information, as of March 2009, the foreign investment net balance amounted to COP$15.7 billions, thus barely accounting for 0.9% of the portfolio.

To monitor exposure of the securities markets to the crisis, AMV worked out the Risk of Contagion Vulnerability Index (IVRC), taking into account the equity links of financial intermediaries with foreign financial institutions and portfolios (Eichengreen, Rose, & Wyplosz, 1997) and (Forbes & Rigobon, 2001). Under this measurement, with the external shocks, the Colombian securities markets has had a medium-high risk level since October 2008, and during the past months vulnerability has increased slightly, mainly on financial institutions with equity linkages abroad.

Nevertheless, financial intermediaries have reduced their level of investments abroad, mitigating their mark-to-market losses. Indeed, benefits accrued from foreign investment pricing since the time of purchase until March 2009 amounted to COP$1.2 billions, thus evidencing the quality of such investments.

In the aggregate, statistics show sound profits as a result of financial institutions good performance. At the end of 2008 profits in the financial system amounted to COP$10.8 billions. Credit banks accounted for COP$4.8 billions and financial funds (Pension Funds, Severance Funds, Mutual Funds, Funds under Trust, etc.) accounted for COP$4.2 billions. It is worth mentioning that in December 2008, financial funds had profits of COP$1.6 billions, mainly due to the appreciation of public debt bonds.

The strong profits are reflected in high and stable profitability indices. In 2008, the financial system ROA was 2.3%, 0.1 percentage points higher than in 2007. A similar trend can be observed in the banking sector where, since 2005, recovery of the traditional financial intermediation has led to more stability of income generation, unlike the aftermath of late 1990s crisis when the main source of banking profitability was treasury operations with a high component of volatility (Figure 13).

AMV grades the risk for each intermediary in the securities market, taking into account the value of the foreign securities, the share of the foreign exposure within the whole portfolio, the income statement resulting from the exposure to foreign securities, the ratio between accrued losses and foreign exposure, the average term of the foreign portfolio and the theoretical annualized volatility. Additionally, in the case of stock brokers firms, the ratio between brokerage agreements and operational income. The exercise has been made with a sample of 121 brokers from the securities market.
Figure 13
Gross Margin Break-out as an Asset Percentage

Source: Financial Superintendency of Colombia and Colombian Banking Association (Asobancaria).

145. Today, the profitability index of the banking system ranks in the average for the region and the solvency index is 9% above the regulation requirement; likewise for the remaining credit institutions (Figure 14 and Figure 15).

Figure 14
ROA of Latin American System (Dec-08)

Source: Financial Superintendency of Colombia and Colombian Banking Association (Asobancaria).

iii. Risk Management System in Colombia

146. Since the financial crisis in the late 1990s, financial institutions and regulators undertook the development and implementation of comprehensive systems of financial risk management, with capital requirements consistent with the financial institutions risk exposure, appropriate
regimes of anticyclical provisions and the implementation of methodologies for risk management in line with the international standards set out by bodies such as the Basel Committee and IOSCO (International Organization of Securities Commissions).

147. In less than a decade the risk management of the Colombian financial system has been transformed. Creation of the risk market management system (SARM), the risk operational management system (SARO), the risk liquidity management system (SARL), and the risk for money laundering and terrorism financing management system (SARLAFT) are all outstanding developments.

148. The SARM, enacted by the SFC, is based on the 2006 recommendations of the Basel Committee. This system includes the implementation of the treasury book as an input for risk market assessment, the modernization of methodologies used for calculating the financial institutions’ risk exposure\textsuperscript{27}, the issuance of basic guidelines required for the construction of internal assessment models, and the establishment of vertical policies regarding top management accountability.

149. Since 2002, the industry and the overseer have worked out together a management risk system based on the establishment of internal models of risk management, or what Basel designates as internal rating based approach (IRB). There are also benchmark models for commercial loan portfolios and consumption loan portfolios.

150. Given the procyclical nature of regulatory capital requirements a major recommendation - derived from the crisis - is the reduction of such effect. The introduction of regulation that allow regulatory capital increases during the expansion stage of the economic cycle – when losses for credit risks are less than the historic trend – create a surplus deemed to be used when losses increase during the contraction stage of the economic cycle. Consequently, the likelihood of bank bankruptcies is reduced and limits the growth of the banking book during the expansion stage of the economy, thus reducing leverage and bubble creation, all of which translates into less systemic risks.

151. It is worth underlining the efforts made by the industry and the supervisory body for the introduction of anticyclical provisions, included in Chapter II of the SFC Basic Accounting and Financial Circular. Such capital requirement regime is one of the most recurrent recommendations derived from the crisis: a surplus is created during periods of credit expansion which offsets subsequent potential defaults, and reduce the influence of the banking system in deepening the economic cycles of the real economy\textsuperscript{28}.

152. The third element to highlight in the structure of the comprehensive risk management system in Colombia, is the establishment, between 2007 and 2008, of a management system for operational risks which enables financial institutions to efficiently identify, measure, control and monitor such risks, in accordance with their structure, size, corporate purpose, and support activities\textsuperscript{29}. To that effect, the SFC requires that the financial institutions establish an independent unit exclusively devoted to manage operational risks, based on a system that commits the institution as a whole and external agents like fiscal auditors to oversee such risks.

153. A fourth element is the implementation in 2008 of the liquidity risk management system (SARL). This system sets out the responsibilities that risk managers, boards of directors, and control bodies must assume in the development of a culture and of an organizational

\textsuperscript{27} The SFC modified the quantification methodologies of the initial 2007 model, moving from matrices of variance and covariance (risk model metrics) to the measurement system of individual factors suggested by Basel (Asobancaria, November 2007).

\textsuperscript{28} Anticyclical provisions slowdown credit growth during the expansion stage, and during contraction reduce the need to cut down on loans to keep the solvency constant when capital declines as an effect from losses.

\textsuperscript{29} Chapter XXIII of the SFC Basic Accounting and Financial Circular
structure to manage the financial institution’s liquidity risks. The system also requires a quantification model to assess the financial institution’s potential risk of failing to promptly satisfy its settlement obligations.

154. Colombia has pioneered the implementation of a system to prevent the use of financial institutions as a vehicle for money laundering or terrorism funding. To that effect a management risk system was created based on the international standard of the Basel Committee. Following the Basel approach, the system does not call for additional capital as it gives similar treatment to the legal and reputational risk components.

155. During the last decade Colombia made significant progress on financial risk management, adopting and implementing highest standards and innovative financial rules (countercyclical provisions loan losses, quantification methodologies including natural stress scenarios adjusted to the financial institution risk profile, and risk management systems matching the Colombian political and economic reality).

iv. Financial Innovation and Pricing

156. The newly created financial instruments played an important role in deepening and accelerating the current financial crisis. Notwithstanding, those instruments facilitated access to credit resulting in increases on the volume of credits granted as well as the reduction of costs. The consequence was excessive optimism and risk underestimation, which subsequently led to relaxation in the criteria applied for the granting of credits.

157. One of the consequences of financial innovation has been risk-transformation and risk-spreading, making possible a reduction in the amount of regulatory capital, and the allocation of risk to those willing to bear it. On example are mortgage portfolios which risks are transformed and spread-out through securitization.

158. In Colombia, the mortgage portfolio origination and securitization system and its regulation is different from United States’. Despite the international crisis, in Colombia the growth of securitized mortgage portfolios has been steady. Whereas in 2002 the securitized mortgage portfolio amounted to COP$415.000 millions in February 2009 it reached COP$4.1 billions.

Figure 16
Securitized Mortgage Portfolio in Colombia

Source: Titularizadora Colombiana.
159. In Colombia, origination of mortgage loans is strictly regulated. Decree 145 of 2000 provides a cap of 70% of the real property value as the maximum amount of financing\(^{30}\), and the value is referred to the purchase price or an independent appraisal. Further, the first installment may not exceed 30% of the family income. Moreover, mortgage lenders must set out loan policies to identify parties eligible for credit.

160. Unlike Colombia, in the United States the debt/guarantee ratio was greater than 85%, the installment/income ratio was greater than 55% and the origination was made by mortgage brokers (with misaligned incentives), that were neither the lenders nor the managers of such loan portfolios (Colombian Banking Association, 2008).

161. In Colombia, the securitization process rests on strict origination rules and involves high management standards of loan portfolios that are reflected on the underlying assets accepted by *Titularizadora Colombiana* as issuer of mortgage-backed securities. One portion of the tranches is held by *Titularizadora* and by the originating banks and reflected on their balance sheets. In the United States, the system was different: all tranches were distributed to the market and the risk exposure was not reflected on the originators’ balance-sheet and, therefore, it was not possible to forecast the losses produced by those products, even when housing prices collapsed.

162. In Colombia, on the other hand, there are no re-securitized instruments, which complexity and external mechanisms of credit alteration (derived from the loan) render the risk assessment highly complex and increase the leverage.

163. To conclude, risk transfers through securitization are performed with loan portfolios originated under strict standards and strong collateral protection. In addition, structuring of those securities incorporates hedges against late payment and prepayment risks, resulting in the transfer of risks to the securities markets through instruments with good quality underlying assets.

164. The newly created financial products that were at the center of the crisis, such as credit derivatives are prohibited under the regulation and, other financial products such as ABCPs and ARSs are not offered.

165. As mentioned in section ii, the risk exposure of Colombian financial institutions to financial assets abroad is relatively low and has been declining. Furthermore, the fact that such investments have been appreciated means that these are highly safe.

\(^{30}\) The cap is 80% for social housing
166. The non-existence of newly created products in the financial institutions’ portfolios entailed that the financial crisis did not produce mark-to-market losses (Figure 17). In August 2008, profits were close to COP$18.5 billions. In November of the same year profits reported were close to COP$8.6 billions and, in March 2009 profits rose to COP$21.3 billions.

167. Financial innovation is not, per se, the cause of the crisis. The crisis has been caused by lack of transparency and regulation on the financial products being developed. Among the recommendations, it has been highlighted the need to enhance transparency in the pricing of illiquid assets (corporate debt and structured products) and the need to settle credit derivatives through a centralized exchange or a clearance house.

168. In Colombia, measures are being promoted to enhance transparency of the securities markets through elimination of regulatory arbitrages – the type of financial intermediaries allowed to trade and the transactions likely to be traded in the OTC market – and the establishment of homogenous transparency rules for the OTC market.

169. Since 2003, new standardized pricing methodologies for bond and equity instruments have been developed. In 2008 rules regarding behavior of securities dealers in the derivatives market were set out and, methodologies for pricing “plain vanilla” products were enacted. However, there are no standardized methodologies for exotic derivatives, although there are criteria for their pricing.

170. Unlike the experience in developed countries, the problem of transparency and, consequently, the problem of pricing in periods of scarce liquidity have been reviewed in Colombia for many years. Hence, development of complex products with little transparency has been minimal or inexistent as well as the exposure to products developed abroad.

v. Rating Agencies in Colombia

171. Most of the attention of the international crisis has been focused on rating agencies. Therefore, it is worth reviewing what happened with these agencies in the foreign markets with respect to risk rating, and the current status such activity in Colombia and its regulation.

172. The first conclusion – which all authorities of industrialized countries agree on – is that institutional investors’ due diligence cannot be replaced with rating agencies. In Colombia, as
a result of the high concentration in some of the highest notches, risk ratings do not replace investors’ due diligence.

173. Indeed, Figure 18 shows that as of April 2009, 66% of the ratings were AAA and AA+ ratings, derived from restrictions on pension funds, severance funds, and insurance companies where the only admissible investments should be BBB- or higher. This regulation has led fund managers to establish effective floor investments with AAA rating. (Echeverry, Navas, & Gómez, 2008).

174. High concentration on top notches entails that the balancing of portfolios by credit risk is made through internal analysis undertaken by investor managers, with limited reliance on rating agencies for the assessment of the securities safety.

**Figure 18**

**Ratings by Type of Institutions***

<table>
<thead>
<tr>
<th>Rating</th>
<th>Corporate</th>
<th>Financial</th>
<th>Loan-Security</th>
<th>Corp-Security</th>
<th>Total</th>
<th>Percentage</th>
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<tr>
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<td>43</td>
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<td>6</td>
<td>77</td>
<td>22%</td>
</tr>
<tr>
<td>AA</td>
<td>4</td>
<td>10</td>
<td>5</td>
<td>2</td>
<td>21</td>
<td>6%</td>
</tr>
<tr>
<td>AA-</td>
<td>2</td>
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<td>7</td>
<td>2</td>
<td>22</td>
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<td>12</td>
<td>3%</td>
</tr>
<tr>
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<td>1</td>
<td>1</td>
<td>4</td>
<td>5</td>
<td>1%</td>
</tr>
<tr>
<td>A-</td>
<td>2</td>
<td>3</td>
<td></td>
<td>5</td>
<td>5</td>
<td>1%</td>
</tr>
<tr>
<td>BBB+</td>
<td></td>
<td>8</td>
<td>1</td>
<td>9</td>
<td>9</td>
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</tr>
<tr>
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<td>12</td>
<td>1</td>
<td>14</td>
<td>14</td>
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</tr>
<tr>
<td>BBB-</td>
<td>3</td>
<td>7</td>
<td></td>
<td>10</td>
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<td>3%</td>
</tr>
<tr>
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<td></td>
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<td>2</td>
<td>2</td>
<td>1%</td>
</tr>
<tr>
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<td></td>
<td>1</td>
<td>1</td>
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</tr>
<tr>
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<td></td>
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<td>1</td>
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<tr>
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</tr>
<tr>
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<td>129</td>
<td>132</td>
<td>26</td>
<td>358</td>
<td>100%</td>
</tr>
</tbody>
</table>

*Includes Issuers’ rating, Ordinary and Subordinated Bonds, Securitization of loan portfolios and securitizations other than real property.

Source: BRC and DCR Colombia, AVM calculations.

175. The U.S dollar value of tranches securitized with AAA rating31 in the United States is close to 79.2% (Benmelech & Duglosz, 2009) whereas in Colombia the share in Colombian pesos of tranches with AAA rating is close to 83%32.

176. However, it is worth highlighting an important difference with the structure of American securitization. Whereas in the United States AAA ratings reflect likeliness of defaults stressed with the information of the dot.com crisis when housing prices did not slowdown, in Colombia, the information of the 1999 housing crisis continues to be the stress event for tranches involved in securitization. Although this fact is not reflected in a lower proportion of AAA ratings, it is clear that it provides a significant support to securities issued, which is taken into account by rating agencies and may explain the high proportion of tranches with AAA rating.

177. From a regulatory perspective, Colombia has made progress in the establishment of international standards in connection with rating agencies, their technical committee and methodologies. Decree 1076 of 2007, which amended Resolution 400 of 1995, prohibited agencies, managers and members of the technical committee from providing advisory in securities markets; investing on securities or collective funds being rated; and, abstaining in the event of lack of independence. Furthermore, the Decree requires that all rating

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31 Tranches without rating are excluded
32 The April 30 UVR was selected as exchange value. Public information of ratings from BRC Investor Services and Duff and Phelps Colombia.
methodologies should public with a prospective approach and the inclusion of objective and quantifiable available facts.

178. The SFC Resolution 2167 of 2006 regulates the conformation of the technical rating committee. This committee has the responsibility of establishing methodologies and approving ratings.

vi. Overview on the Institutional Scheme of Regulation and Oversight in the Colombian Financial System

179. One of the primary causes of the current financial crisis is the inability of financial market overseers, for instance in the United States, to identify and evaluate the market consolidated risks. The reason is the multiplicity of overseers, the duplication of their functions, the competition among regulators, and the lack of formal mechanisms of cooperation and communication.

180. The Colombian financial market has several regulators but oversight is concentrated in one body: the SFC. This is a substantial difference with regard to the United States’ structure.

181. The framework of competences of Colombian regulatory bodies in clearly established in the Constitution. Notwithstanding, the Constitution left room for interpretation and gave rise to subsequent academic discussions. The Constitutional Court has bridged those gaps, while debates continued to be frequent. The conclusion is that unlike what happened in the United States in Colombia the regulatory bodies have clearly outlined their regulatory competences.

182. Given the multiplicity of authorities with competence to intervene in the economy from the regulatory point of view, article 113 of the Constitution sets out that “The various bodies of the State have separated functions but work together harmonically to achieve their aims”. Thus, the Constitution mandates to work under the principle of unity and coordination and, therefore, regulatory bodies may not depart from it. This is materialized in practice, for instance, through the Coordination Committee on the follow-up of the financial system.

183. In Colombia, oversight over the financial system has been entrusted to one single body, the SFC, without prejudice of other oversight activities by self-regulators, as explained below.

184. Until 2006, the Colombian financial market had two governmental supervisors with independent but interrelated competences in practice: the Banking Superintendency, with regulatory and supervisory competence over banks, insurance companies, pension fund managers, among others; and, the Superintendency of Securities which competences related

33 The following are regulators of the Colombian financial market:

- The Congress: article 150 of the Constitution empowers the Congress to enact laws on economic intervention.
- The Central Bank’s Board of Directors: the 1991 Constitution designated the Board of Directors as the monetary, credit and exchange paramount authority to oversee the currency’s continuance of its acquisition capacity.
- The Government: article 335 of the 1991 Constitution provides that the National Government shall intervene, according to law, in all financial, stock and insurance activities, as well as any other relating the management, utilization and investment of funds received from the public. Likewise, article 150 (19) of the Constitution provides that the Congress shall enact general rules and criteria that the Government must observe in the regulation of the above-described activities.

34 Perhaps one of the more difficult discussions regarding the jurisdiction of capital market regulators refers to the definition of credit authorities in Colombia. In rulings C-021 and C-489 of 1994 and C-208 and C-955 of 2000 the Constitutional Court resolved that credit regulation is part of the credit policy and, therefore, is an exclusive function of the Central Bank’s Board of Directors.

35 In ruling C-478 of 1992 the Constitutional Court defined this principle as “Unitary Political Economy” and, therefore, the Congress, the Central Bank’s Board of Directors and the National Government must act harmoniously in the pursuance of a common goal.

36 Decree 1044 of 2003
to participants in the securities markets not subject to supervision by the Banking Superintendency.

185. The model envisaged the merger of the above-mentioned Superintendencies into the SFC\textsuperscript{37} resulted in a unique oversight body of the Colombian financial market. This surveillance and control body has the responsibility of consolidating information and preparing diagnosis on the market at large, particularly in connection to market risks.

186. The SFC is a technical body pertaining to the Ministry of Finance and Public Credit. The President appoints the Superintendent, a circumstance that may undermine this body’s independence. In 2006, a study over the degree of independence of the financial supervisory body in 148 countries, ranked Colombia in the lowest level together with 67 countries like Chile, Mexico and Costa Rica (Barth, Caprio Jr. & Levine 2006). Independence of the regulatory and oversight body is an international widely accepted standard that contributes to the development of both the markets and the financial industry\textsuperscript{38}.

187. Regarding macroprudential oversight, both the merger of the superintendencies mentioned above and the tasks on financial stability conducted by the Central Bank represent an advantage with respect to oversight structures in which several overseers coexist. On the one hand, the SFC complies with the mandate of preserving the financial stability through an oversight that is matrix-based, that is to say, exercised over all financial institutions and over all risks faced by those institutions. On the other hand, the Central Bank has incorporated the inflation and stability of the financial system, as a core element of control. The foregoing has enhanced the market oversight and the implementation of coordinated regulatory policies.

188. The Colombian regulatory and supervisory model is far apart from the American regulatory and oversight model, where multiple regulators and overseers coexist without a mandate calling for a coordinated action and pursuing a common objective. In Colombia, although there are several regulators, their competences are clearly defined, and the regulators have the constitutional mandate of pursuing coordinated actions to achieve the same objective. Furthermore, in the Colombian model there is just one overseer that aggregates all market information and, in coordination with the Central Bank, assesses and limits all risks and takes adequate precautionary measures.

189. Structure of the Colombian financial market regulation and oversight encompasses “regulated-external” self-regulation (see section 2.h). According to Law 964 of 2005, securities markets brokers have the obligation of self-regulation. This incorporates four primary functions: rule-making, oversight, enforcement and certification\textsuperscript{39}.

190. The self-regulatory body fulfills the four mentioned functions over securities brokerage activities by banks, commercial financing companies, financial corporations, trust companies, pension funds, stockbrokers, among others, as well as over individuals related to those intermediaries. Self-regulation has avoided regulatory arbitrage vis-à-vis active financial institutions in securities markets\textsuperscript{40}. The self-regulation duty also encompasses any product in connection with the securities markets, and therefore, self-regulation functions cover not only the fulfillment of the self-regulatory body rules, but the power to verify and penalize any breaches of law, decrees, stock market regulations and negotiating systems and any other regulatory instrument applicable to securities brokerage.

\textsuperscript{37} The Banking Superintendency and the Superintendency of Securities were merged in compliance with Article 1 of Decree 4327 of 2005
\textsuperscript{38} BIS Principle 1 on effective supervision (BIS, 2006)
\textsuperscript{39} In Colombia, two bodies exercise self-regulation activities duly authorized by the SFC: Bolsa Nacional Agropecuaria and AMV
\textsuperscript{40} Prior to the enactment of Law 964 of 2005 the only self-regulated institutions were stock market brokers
191. The SFC’s regulatory and supervisory competence encompasses self-regulatory bodies. Therefore, any rules enacted by those self-regulatory bodies require the prior authorization from the SFC\textsuperscript{41}. Additionally, those two bodies work under the principle of collaboration and coordination and, to that effect, have signed two memorandums of understanding. Thus, Colombia complies with the two IOSCO’s recommendations regarding self-regulation\textsuperscript{42}.

b. Indirect Transmission Channel

192. The international crisis has had direct impact on the Colombian financial system that has been adequately cushioned through risk policies and regulatory structure. However, there is an indirect channel through which foreign regulated institutions badly affect the domestic investors’ confidence: first, soliciting without strict regulation under the understanding that this activity is regulated by the jurisdiction of origin; second, increasing reputational risks on institutions established in Colombia and which parent companies are established at places where the crisis has had the strongest impact.

193. Regarding soliciting to Colombian residents by non-regulated persons in Colombia, the domestic regulation provides that financial brokers from abroad are allowed to promote and advertise their services, provided that they do so through an office of representation or correspondent.

194. This approach permits achieving a middle ground scheme. On the one hand, it is acknowledged that financial institutions and securities may be subject to considerably robust regulatory standards, similar to Colombian standards or even higher. On the other hand, there are mechanisms that allow the SFC to evaluate the suitability of the financial institution from abroad, its managers and shareholders, and even the supervisory body in the place of incorporated.

195. This regulatory paradigm should be reviewed as a consequence of the international financial crisis. As explained at the outset of this study, even developed markets that supposedly had more rigorous regulatory standards experienced material failures that threatened the market systemic stability. Such circumstance may badly affect the interests of domestic investors that funnel their resources through those vehicles\textsuperscript{43}.

196. The national treatment principle\textsuperscript{44} not only entails according foreigners a treatment free of additional charges, but, also, according foreigners the same charges and obligations which domestic financial institutions are obliged to comply with. It is worth mentioning that given the fact that financial activities are of public interest, most countries reserve their rights to withdraw a license and to deny financial institutions the authorization to participate in given events\textsuperscript{45}.

\textsuperscript{41} The rules are regulations that institutions under supervision of self-regulatory bodies must comply with,

\textsuperscript{42} (IOSCO, 2003)

\textsuperscript{43} In free trade agreements negotiations, mutual recognition of financial regulatory standards of the parties has traditionally existed. Therefore, the liberalization of the financial market services soliciting is allowed and, consequently, non-resident financial institutions – parties of the agreement – may solicit business or conduct active marketing as any domestic financial institution, without additional regulatory requirements. This has been the intention of the free trade agreement negotiated with the United States: Chapter 12 sets out: “the obligations required to entities of a country, shall not be more rigorous than those required to nationals to solicit financial business”. See FTA US-COL Article 12.6. In other FTAs, like the Chilean, there is a distinction between cross-border services and financial commercial services. For the latter there are strict rules of compliance with domestic laws for the financial institution that wishes to solicit business and are subjected to prudential restrictions.

\textsuperscript{44} The World Trade Organization defines national treatment as follows: “the products imported shall be accorded treatment no less favorable than that accorded to domestic products. The same principle applies to the supply of foreign and domestic services, to copyrights and foreign and national trademarks “http://www.wto.org/english/tratop_e/whatis_e/fta_e/fact2_e.htm

197. Even under the subsidiary model in which the capital that supports the domestic operation is independent from the capital of the parent institution, reputational risks have contributed to the contagion effect.

198. Below is an explanation of specific cases where domestic investors’ interests have been badly affected due to regulatory aspects on the soliciting business by financial institutions from abroad.

i. Representative Offices

199. A representative office is an establishment of a financial institution from abroad which purpose is to actively market its products and services in the Colombian market or among its residents.

200. Representative offices may only conduct activities expressly authorized by the regulation, such as: i) management activities in connection with active marketing of the financial institution from abroad and ii) acting as a link between the financial institution from abroad and its customers in Colombia; therefore, the representative office can receive and hand over documentation in connection with the provision of the services, give advise to customers in connection with risks associated to the operation and provide information to customers.

201. The scope of professional advisory given by representative offices to their customers differs from the professional advisory provided by securities brokers under Decree 1121 of 2008. This fact gives rise to a different protection standard which becomes relevant given the high sophistication of securities and investment schemes offered by financial institutions from abroad.

202. The oversight standard of representative offices is not the same as the oversight standard of domestic financial institutions. For instance, the former are not submitted to self-regulation or certification standards.

203. Stanford is an illustrative example of contagion of the crisis through a representative office. The representative office of Stanford Trust Company Limited (STL) was authorized to represent in Colombia several financial institutions of the Stanford conglomerate. Specifically, the representative office was authorized to market the services of four credit institutions, a portfolio management company (trust company), and other nine institutions from the Stanford group.

204. The link between STL with a financial institution regulated in the United States, belonging to the same financial conglomerate and with a representative office in Colombia, was one of the main arguments to convince domestic authorities of the financial and moral soundness of those institutions. When the decision was made, confidence by extension was a reasonable principle and generally accepted in a number of countries.

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46 The regulation of representative offices has had many changes associated with domestic policies on capital flows (Ramírez & Sánchez, 1999). Decree 2558 of 2007 regulates representative offices and correspondent agreements and brings together the existing legislation relating the provision of financial, stockmarket and insurance services by foreign international institutions.

47 Article 9 of Decree 2558 refers to advisory on products marketed and the foreign institution features, whereas in article 1.5.3.3 of Resolution 400 the professional advise is referred to the need of establishing the risk profile and the issuance of suitable individual recommendations.

48 Established in Antigua and Barbuda Islands and the parent company of other financial institutions pertaining to the Stanford Group.

49 SFC Resolution 2331 of 2007.
205. In this regard, two lessons should be learned from the crisis: on the one hand, confidence on standards of apparently more developed jurisdictions should not be absolute; on the other hand, financial institutions established in well known tax heavens should be subject to careful scrutiny before granting authorization for soliciting businesses to Colombian residents, despite the fact that those institutions belong to financial conglomerates established in developed jurisdictions\(^{50}\).

206. It is worthwhile evaluating the existing gaps of the current regulation to prevent that Colombian investors’ interests result badly affected through legally established representative offices. First, any active marketing of services to Colombian residents should be through a representative office or through a correspondent agreement. Second, the concept of confidence by extension should be reviewed, mainly when dealing with tax heavens.

207. Lastly, words like “trust”, “stock exchange” and “securities”, among others, should be restrictively used or subject to special disclosure standards for customers. There was a case where a financial institution’s name included the word “trust” — that, \textit{per se} conveys the notion of confidence — and which marketed a number of products associated with the financial and securities markets, many of which had nothing to do with the fiduciary business to which the name apparently referred to.

1. Correspondent Agreements

208. A correspondent agreement is a contract concluded between a foreign financial or securities firm and a domestic securities broker to promote in Colombia the financial services of the former. The regulation regarding correspondent agreements and representative offices is set out in Decree 2558 of 2007\(^{51}\).

209. The regulation applicable to correspondent agreements has been simplified and is very similar to the regulation on representative offices, to the extent that it may be asserted that both are the same, except that in correspondent agreements the staff is not independent from the foreign institution and does not require a legal representative.

210. Further to the shortcomings of the representative offices set out in the section above, the fact that the same firm promotes its own business and those of third parties may give rise to additional problems. For instance, most likely customers do not differentiate between the products and services of the firm and those of the correspondent. On the other hand, where an insolvency problem or any other issue arises in the financial institution from abroad, distrust may spread over the domestic institution, increasing the risk of domestic contagion.

211. It is worth pointing out that by integrating the regulations on correspondent agreements and representative offices the possibility of assigning the correspondent agreement was eliminated and the marketing of securities or related services through staff of the financial institution established abroad, was prohibited.

212. AMV has received complaints\(^{52}\) from investors where these claim that some domestic entities have exceeded their authorization for undertaking marketing activities as correspondents.

\(^{50}\) Jonathan Winner, former official of the United States Department of State pointed out: “\textit{Being located in Antigua should be a “supreme indicator” (…). “There’s no reason for somebody to be located there” except to take advantage of bank secrecy laws and lax regulation….”} (Bloomberg, 2009)

\(^{51}\) Previously, the \textit{Superintendency of Securities} Resolution 440 of 1995 dealt with the correspondent agreement in an autonomous manner, setting out specific prohibitions and regulations, and provided a different treatment compared with representative offices. This Resolution addressed subjects such as domestic correspondents, assignment of correspondent agreements and prohibitions.

\(^{52}\) Law 964 of 2005 and the related regulatory decrees provide that services associated with investments in foreign securities not registered in the RNV are not deemed intermediation in Colombia and, therefore, AMV has no jurisdiction to deal with those facts.
213. In those cases the domestic entity failed informing the customers as to the particular aspects of the correspondent agreements. As mentioned above, customers have difficulties to differentiate advice with reference to regulations applicable to securities brokers. Customers reasonably expect that in case of problems, the broker’s responsibility remains the same, regardless of the financial instrument or agreement being used.53

214. The same comments regarding the representative office apply to authorizations on correspondent agreements.

ii. Troubled Parent or Related Companies

215. In a context of globalized financial markets, affiliated companies or companies related to parent companies or international holdings may be badly affected by situations of financial stress or market crisis in markets other than the domestic market. Regulation has enabled the establishment of subsidiaries in Colombia and the provision of cross-border financial services, in compliance with the domestic regulations applicable on the legal instrument used. The financial reform approved on June 18, 2009, enhanced the regulation with respect to those instruments, setting out that in the provision of financial and insurance services in Colombia through branches of foreign companies, the interests of Colombian residents and the system stability should be protected.

216. Such regulation has provided prudential elements, including the requirement of capital independent from the parent company.54 There is a big difference between the separation of the parent companies’ capital and their representative offices and the separation of the parent companies’ capital and their branches. The latter case refers to companies that have a net worth independent from the parent company, whereas the representative offices have no independent capital available to guarantee any contingency.55

217. Consequently, subsidiaries of foreign parent companies have their own capital and, to a great extent, shield the domestic financial system vis-à-vis the contagion for crisis originated in other markets.

218. The regulation also provides both an investment regime and restrictions on the operations between the parent company and its affiliates,56 which have permitted to mitigate the risk of contagion in scenarios of crisis.

219. Despite the mentioned regulatory standards, in scenarios of stress as the current international financial crisis, it is impossible to completely eliminate the transmission channels of risks among parent companies and their subordinated companies established in Colombia.

220. The reason is that subordinated companies are always exposed to reputational risks associated with their parent companies. The capital may be badly affected by the financial condition of the parent company and may render a company that used to have a sound financial structure unviable.

221. One example is the stockbroker firm Stanford. One year after the acquisition of the stockbroker firm Bolsa y Banca by Stanford Financial Group, the SEC claimed that

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53 In one case, the customer was not properly informed as to the risks associated to investing on given structured securities, thus resulting in the partial loss of the investment.
54 The Financial System Code calls for a minimum capital to establish a financial institution. See EOSF Article 80.
55 The statement of reasons relating the financial reform states: “Any entity established as a branch shall have the same legal nature of the parent company and shall be backed by the capital of the parent; but, if established as a subsidiary, it shall have its own legal nature and capital. See the Statement of Reasons, draft law financial reform.
56 EOSF, Article 119 paragraphs 2 and 3
57 Reputational risks are defined in the SFC Circular 048 of 2006
companies from this conglomerate located in the United States and in tax heavens have made fraudulent transactions of pyramidal type\textsuperscript{58}. This situation precipitated customers of the stockbroker firm Stanford to queue-up to withdraw their investments, despite the fact that this firm had nothing to do with the incidents abroad. The firm suspended its operations and started to liquidate positions to give the money back to its investors.

222. In conclusion, despite Colombian regulatory measures regarding independence of capital, subordinated companies established in Colombia suffered the contagion risk. Capital losses resulting from the occurrence of reputational risks is a phenomenon that should be further examined.

4. Vulnerability of the Domestic Market

223. The financial international crisis and the problems associated with taking deposits illegally from the public in Colombia make evident the need to bridge some gaps in the domestic regulation. Unscrupulous people may take advantage of those gaps undermining the investors’ confidence and, therefore, those problems must be worked out.

224. Below is a description of situations or products that may badly affect interests of savers and investors and that may be subject to regulatory improvement.

a. Pyramids

i. Boom of Pyramids and Ponzi Schemes in Colombia

225. Between 2005 and 2008 many unlawful schemes of taking deposits from the public were created under the promise of high returns to depositors. Most of them were similar to pyramids or Ponzi schemes. However, some combined their operation with other activities prolonging their collapse and making difficult the endeavors of the authorities to stop their proliferation.

226. As of March 2009 the government had intervened close to 55 firms for taking deposits illegaly from the public with approximately 300 offices all over the country. About COP$2.5 billions and 500.000 families were involved in those schemes, mainly in the provinces of Putumayo, Nariño, Huila and Cauca. The economic impact of pyramids has being felt on productivity and employment indicators.\(^59\)

227. DRFE (Fast Easy Money in Cash) and DMG (David Murcia Guzmán), are the biggest companies reported and captured the attention of the public opinion.

228. Carlos Alfredo Suárez created DRFE in September 2007, promising returns of 150%. In one year he opened more than 60 offices in eight provinces and in four cities only he accepted deposits for the amount of COP$400.000 millions through 94.000 transactions.\(^60\) In November 2008, a number of his offices faced liquidity problems thereby being forced to suspend payments to their customers. Despite the fact that DRFE changed its strategy to attract new depositors and to extend the payment period, most of its customers wanted their money back and riots broke out. On February 19 2009, Carlos Arturo Suárez surrendered before the authorities in Brazil and accepted charges for money laundering and taking deposits illegally and asked forgiveness for the trouble caused.\(^61\)

229. According to the investigations, DMG was created in 2005 as a traditional Ponzi scheme. Soon, its founder, David Murcia Guzmán, combined the scheme of taking deposits with the creation of front companies and the business of selling prepaid cards that customers used for the purchase of goods and services in DMG’s offices. Apparently, DMG promised to give back up to 95% of the money deposited in exchange for the purchase of prepaid cards, offering interest rates of up to 100% over six months. Some people claim that the money DMG used for the purchase of goods came from illegal businesses and, therefore, that it was a scheme of money laundering. (Fedesarrollo, 2008).

230. DMG’s popularity was huge and in just three years became a powerful financial group with at least 42 companies in Colombia and 53 in Panama, Mexico, Brazil, Ecuador, and Venezuela.

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\(^{59}\) Near 90% of the population from those provinces were involved in the pyramids and many left their work because of the illusion of the promised profitability. It is said that in 2008, productivity in the province of Nariño fell 4.1% because of the pyramids. See: El Tiempo: “Pyramids in Putumayo, Nariño, Huila and Cauca accepted 2.5 billions”. 2009

\(^{60}\) El Nacional: Penalties Doubled for taking deposits illegally from the public. November 16 2008

Though the figures available regarding the size of DMG are not clear, some believe that this mechanism affected 400,000 people\(^{62}\).

231. On November 17, 2008, the government took-over DMG Holding and shut down all offices in Colombia. Few days later, David Murcia Guzmán and his collaborators were arrested and some have been convicted for money laundering\(^{63}\).

ii. **Difficulties in Identifying and Suspending the Illegal Taking of Deposits from the Public**

232. According to article 335 of the Constitution, any activity in connection with the management, use and investment of resources taken from the public is of public interest and requires the prior authorization from the State. Since the enactment of Decree 2920 of 1982, taking deposits from the public without authorization is considered a crime, and should be investigated by the Office of the Attorney General; overseeing authorities only have administrative powers\(^{64}\). Article 108 of the Financial System Code provides that the SFC may order the immediate suspension of activities on taking deposits from the public, the corporate entity dissolution, and the fast and progressive liquidation of all operations in connection with such activity.

233. Recent cases of taking deposits illegally from the public have evidenced the authorities’ difficulty in identifying those schemes and suspending such operations. The high degree of informality, the poor accounting and the trend to cover up the real activity with the sale of prepaid cards, have reduced the SFC’s ability to collect evidentiary material.

234. For these reasons, and considering the risk that these activities entail for economic and social stability, on November 17 2008 the government enacted Decree 4333 whereby it declared the state of social emergency for the purpose of adopting fast-track procedures to stop activities of taking deposits illegally from the public. The measures adopted pursuant the state of social emergency enabled the government to take-over any entities that exercise financial activities without prior authorization\(^{65}\), to work out on mechanisms to give the money back to depositors, to give power to Mayors and Governors to shut down offending firms in their respective jurisdictions\(^{66}\), to raise penalties aimed at eliminating sentences with suspended prison for the crime of taking deposits illegally and to compel those that have committed such crime to give the money back to depositors\(^{67}\).

235. Those tools have enabled the government to move fast to restore order and stability. However, it is important to strengthen the legal and regulatory framework with the aim of preventing that innovations in the funds reception, end up covering up the crime of taking deposits illegally. It is also necessary to enhance the means through which people may report the authorities about this type of mechanisms. In line with the international experience, this is the easiest and fastest way to stop activities on taking deposits illegally. The effort made by the Superintendency of Companies of establishing a bounty system encouraging

\(^{62}\) Caracol Noticias. “At least 400,000 Colombians invested money on DMG. November 29 2008.

\(^{63}\) Semana. The secrets of DMG. November 22 2008.

\(^{64}\) Article 316 of the Penal Code: “Anyone who takes deposits from the public, massively and regularly, without the prior authorization from the competent authority, shall be convicted to prison between two (2) to six (6) years and fines up to fifty thousand (50.000) monthly minimum salaries”.

\(^{65}\) Decree 4344 of 2008 provides government take-over through the Superintendency of Companies, grants powers to order take over assets, and sets out procedures for administrative intervention.

\(^{66}\) Decree 4335 of 2008 empowers police authorities to precautionary staying non-authorized activities relating taking deposits from the public and shutting the closing of commercial establishments.

\(^{67}\) Decree 4336 of 2008 provides severe criminal consequences for the massive and regular taking of deposits and stipulates that the failure to reimburse such deposits is a crime. Further, on September 19 2008, the government submitted to the Senate the draft Law 154/08 to amend the Penal Code by increasing the penalties provided in article 316 for massively and regularly taking deposits and creating the crime of non-reporting cash transactions, the transportation and storage of cash. According to the text approved by the Senate in first debate, anyone who commits the crime of taking deposits illegally shall be convicted to prison of 120-240 months and shall be fined up to 50.000 monthly minimum salaries.
people to report information leading to the recovery of goods derived from activities of taking deposits illegally is very useful.68

236. Further, it is crucial to supplement criminal and administrative powers with financial education at national level, enabling people to detect fraudulent and illegal financial schemes and to realize the advantages of saving and investing through financial intermediaries legally authorized for taking deposits.

b. Irregular Trading Desks

237. The fast development of activities connected with securities trading has given rise to a large market whereby some non-regulated private parties offer services such as:

- Buying and selling securities.
- Advisory services on securities trading.
- Discretionary fund management on buying and selling securities.

238. Those entities are usually called irregular trading desks69 and funnel money from the general public to the securities markets without any control, oversight, or self-regulation.

239. Such irregular trading desks invest moneys of third parties deprived from protection or access to prior information allowing them to know the terms and conditions of the transaction. The main feature of this type of activities is the inexistence of clear information to choose the product in conformity with previously known and understood rules.

240. Those irregular trading desks escape to duties and obligations proper of brokers, in accordance with Decree 1121 of 2008, such as: provision of information and documentation, obligations concerning conflicts of interests, discretion, assets separation, pricing, best execution requirements, and finally, the duty of giving advise to investors.

241. The lack of regulatory obligations means that people working for those trading desks and that provide the above-mentioned services, do not comply with the certification and conditions required to experts in the securities markets. Therefore, there is no mechanism to certify the skills of people working on such activities.

242. Many people penalized or questioned by the SFC, the AMV, or the stock exchange – when acting as self-regulator – work for irregular trading desks, and therefore, the ethics of these people is doubtful. There is also concern for the lack of protection of people that decide to accept the services offered by irregular trading desks and that end up investing their savings through such entities.

243. In 2008 a consulting study conducted by international experts70 pointed out that any person or firm that supplies, in a professional manner, services to the public to facilitate their access to the securities markets, should comply with the regulatory standards to protect investors. Therefore, trading desks that facilitate or make transactions in the securities markets on behalf of any investor, should comply with the regulatory standards established for any brokerage activity. Otherwise, those trading desks should be subject to measures provided for people that perform irregular activities in the securities markets.

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68 Decree 44 of 2009
69 Also known as “independent trading desks”. See Communication TRA-2009-134902.1 from Asobolsa to the Ministry of Finance and Public Credit, dated February 27 2009.
70 Elliot Levine from Financial Industry Regulatory Authority (FINRA), and Richard Britton from International Capital Markets Association (ICMA)
c. Forex

244. "Forex" refers to a platform of foreign exchange trading (Dollar, Euro, Yen), operating domestically or internationally, through which any person is entitled to make foreign exchange transactions. Nature of investments through Forex platforms is speculative. Therefore, it is usual that buying and selling through this mechanism entails substantial leveraging aiming at increasing profits vis-à-vis resources invested. Accordingly, this type of investment bears high risks for investors.

245. The Forex market is not an exchange market in the traditional sense. It is a decentralized market where most transactions are made by telephone or through the Internet platform (National Futures Association, 2004). In many cases the decision to enter or exit the market is made by a Forex broker, which gives rise to additional risks derived from a leveraged investment in foreign exchange. Worth is emphasizing that there are behaviors against the clients’ interests, such as the malfeasance or embezzlement and improper execution of operations, given the lack of standards on transactions traceability.

246. Some times, Forex managers guarantee or offer “very likely” attractive rates of return that enhance unreasonable expectations of safety given the nature of the transaction. Finding offers from managers guaranteeing monthly rates of return of 30% or 40% is easy and, offers on the Web or social networks such as Google or Facebook guaranteeing monthly rates of return between 8% and 18%.

247. The high rates of return offered and the lack of regulation imply additional risks. Managers of third party funds that invest in the Forex market comply with the expectations on high rates of return offered by using moneys of new investors, thus becoming a pyramidal scheme.

248. Given the popularity of the Forex market, some people have started to take deposits illegally from the public without the intention of investing a portion of those deposits on that market.

249. There are no international examples of regulation on this investment mechanism. This fact has led to low standards of information to investors and the lack of specific obligations for Forex brokers, such as giving advise, best execution requirements, and asset separation, among others.

250. Given the high financial risk of Forex transactions, as well as the other risks mentioned above, investors are unprotected vis-à-vis losses caused by Forex brokers’ wrongdoings, negligence, or fraud. The more recent international trends regarding this problem point to the need of enhancing the regulation on this type of investments by applying the securities markets regulation (Commodity Futures Trading Commission, 2007).

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71 According to article 249 of Penal Code, malfeasance is a crime: anyone who appropriates for his own benefit or for third parties’ benefit, some one else’s personal property, entrusted to him without conveying ownership thereon, shall be convicted to prison of one (1) to four (4) years and shall be fined with ten (10) to two hundred (200) monthly minimum salaries. In the event of misuse, rather than malfeasance, the penalty shall be reduced to one half.

72 There are no mechanisms to corroborate who is the beneficiary of a Forex transaction, and, therefore, brokers may enter transactions and discretionally assign positions without need to record such transactions.

73 Fraud advisories from the CFTC: foreign currency trading (Forex) fraud. U.S. Commodity Futures Trading Commission http://www.cftc.gov/customerprotection

74 One example of advertising of Forex investments through Internet is the following: “Invest on Forex foreign exchange. Get monthly returns of 18%. Per Col$1.000 you will earn monthly benefits of Col$180” or “Invest on Forex. Get monthly profits of 18%.”

75 Recently, a fraud with the above-mentioned characteristics has been recently reported in Colombia (Semana, 2009)

76 In the province of Valle del Cauca, some investors entrusted their money to Forex Capital that later ceased operations and thousands of investors lost their money. The company promoted its activities as “an alternative of investment and capitalization”, offering monthly interest rates of up to 150%. The Police obtained permission from the Attorney General’s Office to enter Forex Capital’s premises in order to determine the scam amount (Red de Gestores Sociales, 2008).
251. In the United States, the NFA, the SEC, the CFTC and FINRA, enacted legislation aimed at investments made through those brokers. For instance, the NFA established that only firms subject to its regulation might provide services as Forex brokers. Further, those firms are obliged to supply investors with information on the risks of transactions, risks in case of broker’s bankruptcy and the availability of databases where all Forex’s transactions on behalf of their customers are recorded (National Futures Association, 2008).

252. The NFA sets out the obligation to hold reserves to protect investors in case of losses and to hold a minimum capital in order to operate in this market. The NFA also oversees the operators of this market.

253. In Canada, the BCSC requires that all Forex brokers register, self-regulate, have minimum capital, comply with prudential regulation, and have risk management policies adequate for this type of transactions.

254. In Colombia, by contrast, investors attracted by high profitability entrust their resources to irregular Forex brokers.

255. Currently, Forex brokerage firms have no authorization of any kind and are not submitted to oversight or self-regulation, thus facilitating frauds through schemes that end up being multilevel or pyramidal schemes.

256. Recently, the SFC suspended the operations of a number of those firms on the grounds of performing marketing activities of Forex financial services and products without prior authorization. According to the SCF, Forex trading can only be made through representative offices of foreign entities or through entities with correspondent agreements, which require the prior authorization from the SCF in accordance with Decree 2558 of 2007.

257. Resolution 4 of 2009 of the Central Bank provides that the SFC may only conduct Forex trading through foreign exchange market brokers, who comply with minimum capital requirements, prudential regulation, and oversight. This is the most important regulation improvement relating the Forex market. However, given the high risks associated with this product, it is important to enhance regulation standards to prevent wrongdoings that badly affect investors’ interests. Standards on orders processing and traceability are just an example of key aspects to be taken into account to prevent abuses.

d. Agents

258. The agent is the vehicle used by some investors to participate in the securities markets whereby one individual orders transactions to a securities broker on behalf of his client.

259. Use of these transactions originates from family relationships where the father conducts business on behalf of his children. However, there are no restrictions for acting as agent in the absence of family links with the investor.

260. The Colombian regulatory framework does not contemplate this type of transactions. Therefore, the agent conducts his actions within the limits of the mandate conferred by his

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77 The BCSC (British Columbia Securities Commission) is the securities market overseer from the Province of British Columbia.
78 BC Policy 31-601 Registration Requirements (BCP 31-601) [BCN]
79 Resolution 2134, December 26 2008, (Cfx Markets) Resolution 2051, December 26 2008 (Serforex Ltda), Resolution 2133, December 26 2008 (Invest in Foreign Exchange Ltd)
80 Legal opinion 2008031228-001, November 24 2008.
Thus, the powers of the agent have different scope depending on each particular case. Some times, the agent has authorization to engage in activities with different risks for the investor, such as the disposition of dividends, the transferring of funds or securities from or to the client’s account, or the receipt of balance statements relating transactions made on his behalf.

261. Given the fact that some times the agent can make discretionary use of his clients’ resources, the agent may end up making transactions that materially affect his clients’ interests. Investors seek agents due to lack of information relating the existence of investment products and the value added inherent to services provided in person. However, the lack of regulation may lead to misappropriation of resources, excess in the mandate, and non-applicability of obligations proper to securities brokerage. Additionally, clients may not claim or obtain compensation as the agents are neither regulated nor oversight.

262. Currently, efforts are being made to regulate this activity. AMV has introduced Rules that define and enhance the agents’ constraints. Other than that, regulation on this matter is inexistent.

263. Regulations on agents may be focused differently. On the one hand, this activity may be prohibited except when dealing with family relationships. Another alternative is introducing a regulation that creates a special register, thus limiting the framework of attributions, and establishing obligations similar to any other broker. The agent may also be assimilated to a “financial planner”. Finally, agents should be submitted to surveillance by an authority having administrative jurisdiction and, also, be subject to penalties in case of non-compliance with their obligations.

e. Unlawful Marketing of Foreign Insurances in Colombia

264. Although technically speaking the insurance agreement does not entail taking deposits from the public; it is a business where resources from the public are massively managed with the aim of responding to reported claims. Mismanagement of those resources can materially affect the people’s financial interests and is likely to introduce systemic instabilities to the financial system.

265. The phenomenon of brokers from foreign insurance companies offering foreign insurances in Colombia is old. This practice breaches the Financial System Code, which prohibits entering into insurance transactions in Colombia with insurance companies non-authorized to develop

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81 The agent is framed under the scheme of mandate agreements. The relationship between the client and the agent should be assessed within the framework of the principal–agent relationship provided in articles 1262 and 1311 of the Commercial Code. The Colombian securities market regulation does not contemplate client-agent and broker-client relationships in the field of issues related to the securities market. The agent scheme may entail certain advantages as it facilitates intermediaries to reach out clients for the securities market. Agents have incentives to offer advise and orientation on how to make investments through brokers from the securities market. Furthermore, agents provide services such as personal attention, home visits and, ultimately arrive to personal relationships of confidence.

82 The agent may not serve more than 5 clients other than his family. Securities brokers are bound to adopt procedures that allow clients awareness in the sense that the agent does not belong to the firm, that he is not a broker, and also, must inform the client about the consequences of doing businesses through an agent.

83 Internationally, and specifically in the United States exist “financial planners” who provide advise on asset management, securities investment, social security, insurance, etc. Financial planners provide information regarding the management of assets and liabilities of an individual or a family. In a number of countries this activity is subject to self-regulation with the aim of raising the standards applicable on the provision of this service. Certain basic measures have been adopted for the industry, such as the obligation to inform the client on the nature of the business, the obligation of certification, etc. Financial planners in Australia require a license as investment advisor. This license certifies that financial planners have a minimum technical knowledge. The requirements are set out in Regulation Act 146 (Regulatory Guide 146. Licensing training of financial Product Adviser). In Malaysia, other than the need of a certification as financial advisor, applicants must be members of a self-regulatory body recognized by the domestic authorities.
insurance activities in Colombia or through their agents or representatives\textsuperscript{85}. However, there are firms offering in Colombia life insurances and investment plans for early retirement with yearly returns of over 20\%\textsuperscript{86}.

266. Colombians that purchase insurance policies from foreign insurance companies aimed at covering illness or death risks may encounter non-compliance, and therefore, difficulties in the payment of their claims.

267. Likewise, adjustments to some definitions were pending to endow the authorities with better tools to fight against this situation. In the recent financial reform of 2009 passed by the Congress, the authorities introduced some adjustments to the regulation whereby insurance brokers may only conduct brokerage activities in Colombia on behalf of foreign insurance companies only for the insurances mentioned in paragraph 1 of article 39 of the Financial System Code\textsuperscript{87}. In accordance with the first paragraph of this article, except in cases of special insurances, insurance companies from abroad may offer, promote, or advertise their services in Colombia or among Colombian residents.

268. This is an important regulatory development. In the former regulatory structure, the above-mentioned prohibition could be evaded by asserting that the agreement had been entered in a foreign country, despite the fact that the publicity of the product was clearly targeted to Colombian residents.

\textsuperscript{85} Article 39: “Except as provided in the paragraphs of this article, it is prohibited to enter into insurance transactions in Colombia with insurance companies from abroad non-authorized to develop insurance activities in Colombia or through their agents or representatives.

Paragraph 1: “Insurance companies from abroad may only offer in Colombia or to residents in Colombia insurance associated with international maritime transport, international commercial aviation, and space launching and transport (including satellites), covering risks linked to goods transported, the vehicle transporting the goods, and civil liability derived therefrom, as well as insurance covering international transit of goods”.

The Financial Superintendency of Colombia may provide the mandatory registration of insurance companies willing to offer insurance in Colombia or to Colombian residents.

Except as provided in this paragraph, insurance companies from abroad may not offer, promote or advertise their services in Colombia or to Colombian residents.”


\textsuperscript{87} Article 40 paragraph 7: “Prohibition to sell, offer, promote, and advertise insurance policies of insurance companies from abroad. Insurance brokers may conduct brokerage activities in Colombia on behalf of foreign companies, only in relation with insurances provided for in the first paragraph of article 39 of this Code.”
5. Elements to Consider for Strengthening the Regulation

269. The international financial crisis has been a very complex phenomenon given the diversity of factors involved. A number of international studies have put forward many proposals, which have been analyzed in chapter 2.j. Additionally, the annex to this study shows a comparison between the most important recommendations and the current Colombian regulation on the matter.

270. Without prejudice of the importance of such recommendations, this section deals with some of the proposals aimed at solving specific problems of the financial and securities markets within the context of the crisis.

271. First, this section addresses the regulation and oversight structure of the Colombian financial system, to shed light over those aspects that do no need modification. Indeed, introducing adjustments to a scheme that has proven adequate should be a step back in the regulation standards and would create disturbance in the market development.

272. Thereafter, is a discussion on issues that deserve regulatory adjustments. Emphasis is made on those reforms that reduce risks to domestic investors and savers in cases of serious crisis.

a. Issues that Should Remain Unmodified: Regulatory and Oversight Structure of the Financial Market

273. Based on the discussion of the regulatory and oversight structure of the financial market in developed countries it is worthwhile analyzing the Colombian regulation and oversight and put forward some adjustments.

274. The Colombian and developed countries situation are not fully comparable, and many gaps and failures of the regulatory structure observed in countries like the United States are not present in the Colombian case.

275. In Colombia there are a number of prudential measures in connection with solvency (minimum capital and adequate capital), anticyclical provisions, liquidity, debt and investment classification, etc., that, as a whole, constitutes a sound prudential regime to safeguard the system resources. Moreover, stability of the financial system has been protected from the macroprudential standpoint through a close coordination between the financial oversight by the SEC and the anticyclical monetary policies by the Central Bank.

276. The international discussion on the oversight structure has not focused on the unification of regulatory and oversight tasks in the Central Bank. Here, the key issue is - regardless of whether or not this task should be conducted by the monetary authority, by an oversight body or by both – the need of consolidating the market information to conduct an effective oversight.

277. Regarding standards of microprudential oversight and risk assessment, Colombia has made substantial progress on the implementation of management systems and international practices of internal control. However, those measures should be accompanied with standards of overseer independence in order to protect the oversight body from political influences or pressures from the industry. To this end, the financial Superintendent should be appointed for a fix term and he/she should have legal support when sued for the adoption of legitimate measures in the discharge of his/her duties.

278. Unlike the United States, Colombia conducts consolidated oversight over the financial market. Therefore, there is no need of introducing adjustments to such structure since it has proven useful in the prevention of contagion effects from the international crisis.
279. The financial crisis made evident the fact that there are risks that can only be observed at the level of financial conglomerates and that the soundness of a particular financial institution depends on the soundness of the economic conglomerate. Regardless of the legal means under which a financial institution or a group of financial institutions is established, when their interrelation, size, and leverage bear risks for the financial system stability, the conglomerate should have the obligation to disclose information and, further, be submitted to surveillance by the overseer. The financial reform bill introduced in the Congress in February 2008, included broader powers for the SFC to request information from any legal entity of the conglomerate to which the financial institution belongs, and to bar firms pertaining to complex and non-transparent financial conglomerates from establishing in Colombia. In light of the international recommendations, it is worth reconsidering this proposal, which is one of the proposed reforms in the United States.

b. Issues that May be Amended

280. There is room to improve the current structure of the Colombian financial regulation to effectively protect domestic savers and investors. First, the regulatory framework should be extended to products that involve third parties’ fund management or the marketing of financial investment products offering high returns. Second, it is worth reviewing the criteria determining the activities that can only be conducted by firms subject to oversight. Lastly, alternatives should be evaluated to limit the activity of marketing products that are exclusive of financial institutions submitted to surveillance. Such recommendations pretend endowing the oversight and control authorities with additional tools to enhance preventive and corrective actions undertaken in relation to the provision of non-authorized services.

281. It is worth mentioning that the financial reform enhances the protection of financial consumers through the customer advocate. This is an improvement of the regulatory structure and coincides with the proposals put forward in this regard in the United States.

282. Financial services in Colombia can be classified in three categories according to the regulatory standard they have to comply with. First, “white zone” activities, encompasses products and services provided by financial institutions established in Colombia and subject to highest regulatory standards.

283. “Grey zone” activities, encompasses products that have a certain level of regulation but with space to enhance their regulatory standard. An example is the marketing to Colombian residents of products and services from financial institutions established abroad, through representative offices and correspondent agreements. In this case, the regulatory standards are not sufficiently high, and as explained before, this was an indirect transmission channel of the crisis.

284. “Black zone” activities, which encompasses services and products illegally supplied and unregulated. Those activities bear high risks for savers and investors and undermine the people’s confidence.

285. Most of the activities in the table below correspond to “passive operations”, that is to say, agreements in which the financial institution accepts deposits to be invested and to be later reimbursed with fix or variable returns. Other activities are brokerage activities, which facilitate the clients’ access to the securities markets or to the market of other financial assets with alike economic purposes.

<table>
<thead>
<tr>
<th>Zone</th>
<th>Securities Market and other</th>
<th>Deposits Market</th>
<th>Insurances</th>
</tr>
</thead>
</table>


### Investment Financial Assets

<table>
<thead>
<tr>
<th>Stock Exchange</th>
<th>(Financial)</th>
<th>(Insurer)</th>
</tr>
</thead>
</table>
| White          | • Mutual Funds  
• Third Party Portfolio  
• Commission Agreement  
• Over-the-Counter Buying and Selling  
| • Current Account  
• Saving Account  
• CDTs y CDATs  
| • Insurance Contracts |
| Grey           | • Representative Offices  
• Correspondent Agreements  
• Forex  
| • Representative Offices  
• Correspondent Agreements  
| • Alike Services (Excl. Advance payment of funeral services) |
| Black          | • Irregular Trading Desks  
• Agents  
| • Pyramids  
• Illegal Deposit Takers  
| • Marketing foreign insurance services |

286. Products in the white zone are the only ones with high regulatory standards and high levels of protection for investors and savers. Therefore, the regulation should aim at eliminating the rest of the products or, otherwise, moving them towards the white zone.

287. A number of factors have given rise to grey and black zones. The regulatory proposals discussed below seek solutions for this problem.

1. **Investment and Services Activities that should be Subject to Government Oversight**

288. The Constitution of Colombia has set out that the financial, stock exchange, and insurance activities as well as other activities in connection with the management, use and investment of deposits taken from the public are subject to government inspection, surveillance and control, on the grounds that such activities are likely to materially affect the public interest.

289. However, in given occasions regulation may not be accurate or comprehensive enough to outline the border between activities that should be subject to regulation and government oversight and those that should not be subject to such standard. Management of third parties resources entails high social risks and, nevertheless, sometimes is not subject to adequate regulatory standards.

290. The current legislation does not encompass some financial assets not included under the securities definition, which are alternative investment opportunities but, that given the fact that are fungibles, may fulfill similar economic functions. Such is the case of foreign exchange, which is a financial asset that technically speaking is not a security but that has originated the development of an important industry offering people attractive investment alternatives.

291. Taking the United States as reference, the securities definition entails the notion of investment contract. The definition is given by jurisprudence through the Howey test, that broadly speaking includes the following elements: i) money investment; ii) in a company; iii) with the expectation of a profit; iv) depending on somebody else efforts.

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88 Central Bank Resolution 4 of 2009 sets out that Forex products can only be offered by IMC’s. However, brokers subject to day-to-day oversight have not started the massive offer of this product and, therefore, the standards of conduct and traceability are unclear.

89 See (Soderquist, 2005).
292. Any investment asset under any legal structure – set forth by the dynamics and innovation of financial markets – creates risks for the investors, and is worth asking if it should be assimilated to securities. Thus, brokerage of such instruments should be restricted to firms that fulfill high standards of internal control and that are subject to oversight by the SFC. On the other hand, trading of such assets should be subject to the whole catalog of obligations applied to securities brokers and developed to enhance the market transparency and people’s confidence. Examples of those obligations are the management of conflicts of interests, assets separation, best execution requirements, etc.

293. In order to tackle this problem it should be convenient to evaluate alternatives of regulatory adjustments, such as: (i) Modification of the general notion of securities set out into the Law 964 of 2005, to include fungible financial assets that under the trading conditions become an investment or speculative alternative aiming at obtaining financial returns. (ii) Providing that such financial assets are considered securities or similar securities, as these fulfill the conditions set out in the definition provided by the above-mentioned Law, on the grounds that the list of elements of article 2 is an enumerative list that may be developed by the government.

294. Services provided by agents explained in section 4.d are not contemplated under the regulation. Those services are not considered a brokerage activity but are conducted massively and are likely to badly affect the public interest. The lack of legislation allows some people to manage huge capitals without any standard or accountability.

295. There are no effective mechanisms to enable the authorities to effectively deal with this type of irregularities, given the fact that a veil of legality covers persons that conduct this type of trade, to the extent that they consider themselves as third-party agents. To render the matter more complicate, some activities conducted by those agents are not unlawful, such as in the case of family relationships or company managers.

296. A number of regulatory alternatives may be considered. One choice is restricting the activities of independent agents to services provided by individuals linked to brokers and to authorized products such as the management of third-party portfolios. Another choice is regulating the agent’s activities through standards of professionalism and registration and, obligations vis-à-vis their customers. Such obligations may include good management of conflicts of interests. Additionally, forbidding agents to discretionally make decisions regarding third-party resources.

ii. The Notion of Massively and Regularly Taking Deposits and Activities Exclusive to Entities Subject to Oversight

297. The notion of massively and regularly taking deposits, incorporated into Decree 3227 of 1982 and amended by Decree 1981 of 1988, is at the heart of the Colombian regulatory structure relating financial and securities activities.

298. Article 189 of the Political Constitution of Colombia grants the President of Colombia the function of exercising inspection, surveillance, and control over persons that use and invest deposits taken from the public.

299. The notion of taking deposits from the public in Law 964 of 2005 is the cornerstone to define the scope of government intervention as well as the notion of securities. Article 1 of the Law states that the Government shall intervene in the management, utilization, and investment on securities of resources derived from activities relating the taking of deposits from the public. Regarding the notion of security, the Law states that securities are negotiable rights that are part of an issuance, when the purpose or effect thereof is taking deposits from the public.
300. On the other hand, Law 599 of 2000 provides that the massive and regular taking of deposits from the public is an offense and provides imprisonment penalties and fines.\(^{90}\)

301. This notion is crucial for the Colombian regulatory structure since, ultimately, it determines which are the activities that financial institutions may exclusively perform. Therefore, the review of such notion may be an important step leading to more effective protection of domestic savers and investors.

302. The declaration of social emergency through the November 17 2008 Decree\(^{91}\), enabled the government intervention to suspend some operations considered irregular. Further to the notion of legally taking deposits from the public, the notion of “unauthorized funds reception, such as pyramids, prepaid cards, sale of services and other massive operations and transactions [that] generate abuse of law and breach of law by exercising an irregular financial activity” was incorporated.\(^{92}\)

303. The notion of “unauthorized funds reception” has turned out to be of utmost importance to avert the social turmoil resulting from the pyramids and other type of transactions explained above. This notion is complementary to the traditional notion of massively and regularly taking deposits from the public, enhancing the financial and securities regulation.

304. Recent events in Colombia and in other countries show that the schemes set up to get resources from the public are reinvented under different legal schemes; therefore, it is very important that regulation keeps updating.

305. The evaluation of alternatives to broaden the notion of taking deposits is worthy, given its key relevance under the financial regulation. However, any proposal in that regard should be examined carefully. Shown below are some relevant aspects to be worked out in any proposal.

306. The term “taking deposits” has different connotations. Decree 3227 of 1982 regulates the traditional definition of massively and regularly taking deposits. According to such Decree, the notion of taking deposits is associated with the existence of a number of obligations vis-à-vis the public, a number of mandate agreements under the modality of full discretionary powers and the realization of repo transactions on debt or investment securities.\(^{93}\) In addition, the relationship between the amount of money received and the net worth of the firm must be verified, or the fact that the resources received result from public offerings.

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\(^{90}\) Law 599 of 2000, article 36, amended by Decree 4336 of 2008.

\(^{91}\) Decree 4333 of 2008

\(^{92}\) Decree 4333 of 2008, article 2.

\(^{93}\) Decree 3227 amended by Decree 1981 of 1988

Decree 2920 of 1982 provides that an individual or a legal entity takes deposits massively and regularly from the public in any of the following cases:

1. When the liabilities owed to the public are made up of obligations owed to more than twenty (20) people or more than fifty (50) obligations, incurred directly or through a third party. Liabilities to the public mean the amount incurred by receiving money on loan basis or in any other terms that do not provide goods or services supply.

2. When, jointly or separately, more than twenty (20) mandate agreements are entered into in a timeframe of three (3) consecutive months, for the purpose of managing funds of its principals under the modality of full discretionary powers or, for the investment on securities in the agent’s judgment or, in the event of sales relating debt or investment securities with the obligation for the buyer of transferring the ownership of securities of the same kind, on demand or on a mutually agreed term, and against payment of a price. To determine the three (3) month term referred to above, the initial date shall be that corresponding to the mandate agreements or of the sale transactions.

Paragraph 1. In any of the foregoing cases any of the following conditions must be complied with:

a) That the total amount of money received for the set of transactions mentioned above, exceeds 50% of the net worth of such individual; or

b) That the respective transactions are the result of public or private offerings to unnamed persons, or the result of using any other system with the same or similar effects.
307. The Constitution of Colombia and Law 964 of 2005 make reference to the notion of taking deposits, without any additional qualification. Apparently this notion differs from the notion of massively and regularly taking deposits. At least in the case of the securities markets law, there are circumstances which are understood as taking deposits through the sale of securities, without any observable element of massively and regularly taking deposits, as set out in Decree 3227 of 1982. Indeed, Law 964 states that a vehicle for taking deposits through securities, consists of the issuance of equities, given the fact that such instruments enable the funds reception. However, an issuance of equities does not entail the notion of massively and regularly taking deposits, like in credit relationships or the entry into mandate agreements with full discretionary powers.

308. Given the fact that the notion of taking deposits is fundamental for determining which activities may be undertaken exclusively by oversight entities, it is worth evaluating the impact of different connotations of this notion.

309. Another aspect that is worth considering refers to the inclusion of a new notion, similar to and related to taking deposits, which is the “unauthorized funds reception”, through Decree 4334 of 2008. In principle, this activity should be included within the notion of massively and regularly taking deposits from the public, on the grounds that an activity that has a social impact should be restricted. However, there are not technical reasons for the creation of an additional notion, despite the fact that the notion of unauthorized funds reception was very useful in averting the social crisis.

310. The traditional definition of massively and regularly taking deposits entails a challenging burden of proof for the authorities. Indeed, it is always necessary to prove the existence of contracts that give rise to liabilities or contracts with full discretionary powers, among others. To that end, the authorities must undertake a costly, complex and time-consuming investigation given the need to collect concluding documentation or testimonies to prove the existence of such contracts.

311. Despite the challenges of the regulation, the SFC has adopted measures against people taking deposits illegally from the public. However, it is necessary to rely on regulatory tools to fight against the phenomena of shadow financial activities. The mere fact of offering services to manage funds from the public in exchange of a return should be considered as taking deposits, without need of demonstrating the existence of any contract or considering the amount of resources involved vis-à-vis the firm’s net worth.

312. In conclusion, the recent events have demonstrated the need of reviewing the notion of taking deposits from the public to give clarity as to the exact meaning of practices exclusive of oversight entities, and the need of improving the authorities effectiveness to fight against irregular phenomena. The foregoing, without prejudice of studying any other aspects in connection with the current definition of taking deposits from the public, keeping in mind the role such notion plays by as a cornerstone of the financial regulation.

iii. Soliciting Business or Services Exclusive of Securities Brokers

313. In other countries, a key criteria to define the notion of activity exclusive of firms subject to oversight is “soliciting” or active marketing. According to this criteria, undertaking activities to advertise alternatives for investing on securities, offering returns for the management of portfolios, or selling insurance coverage, should be considered, as such, an activity regulated regardless of the type of agreement or label used.

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94 Law 964 of 2005, Article 2. Under such Law, selling securities (equities, in this case) is a manner of taking deposits from the public.
95 See Resolution 0471 of 2009 – Case of Mutually Global Investment Ltd.
314. As a general rule, the activity consisting of approaching the public to offer services that encompass savers and investors entails risks for the public interest. Unfulfilling profits expectations or losing the resources can materially affect the confidence in funneling financial resources through traditional intermediation channels – shares, bonds, or other securities. Such harm to confidence materially affects the possibilities to expand financial services and to develop the securities markets.

315. It is unclear why massively offering to the public the possibility of undertaking, facilitating, or managing securities transactions is an activity exclusive to oversight firms. It could be possible that an individual may professionally and publicly develop the activity of channeling resources through soliciting without any enforcement measure or punishment from authorities.

316. To the extent that this activity has the unambiguous purpose of regularly and professionally bringing together sellers and buyers of securities, the regulation should provide that this activity should be exclusively performed by financial intermediaries.

317. One of the main advantages of this regulatory approach is to facilitate control by the authorities, bearing in mind that in this case the regulated activity is defined by objective facts which prove is less complex in comparison with other regulated activities. Indeed, proving that the commission agreement was entered with an entity not subject to oversight – for the purposes of enforcement measures in case of infringements – requires, in the first place, proving the existence of the agreement. Failing evidence as to the existence of a legal link, demonstrating that a transaction between two parties outside the oversight scope was part of a commission agreement for buying and selling securities is too complex.

318. If soliciting business or the performance as market expert vis-à-vis investors are also considered activities exclusive of financial intermediaries, for the authorities it suffices to demonstrate the reiterated fact of marketing or the recurrent buying and selling transactions by experts on behalf of investors. In such cases advertising on newspapers or reiterated transactions with third parties would suffice as evidence, with no need of demonstrating the legal nature of agreements.

319. This regulatory caveat includes situations of marketing services for massively buying and selling securities to investors and the principle included in the domestic regulation that companies established abroad are not empowered to market financial services or securities to Colombian residents, except through representative offices or correspondent agreements.

iv. Facilitate Controls from the Standpoint of Demand for Services

320. For the State it is extremely costly to police firms in the “black zone”. Effectiveness of any action by the State is diminished by the need of coordination among administrative and criminal authorities, the existence of legal façades hiding the identity of the actual promoters of irregular activities, and the utilization of legal strategies to hinder the action of the authorities. This is more troublesome when the number of firms offering irregular services is large and a generalized phenomenon.

321. This does not mean that authorities should suspend or reduce their efforts to neutralize this phenomenon. Undoubtedly, continuity of corrective activities is crucial for the solution. However, complexity of the problem suggests the need of using additional mechanisms to effectively reduce the existence of financial and securities services under the “black zone”.

322. One of those mechanisms may be the system of market alert where the authorities may disclose a listing of firms that are not registered in the National Registry of Stockbrokers (RNAMV) as financial intermediaries or that are not authorized to massively and regularly taking deposits from the public. This listing may be constructed on the grounds of queries
filed by savers, investors and the general public before the authorities, on whether or not a firm or individual has authorization to conduct financial activities. The listing should be limited to entities not subject to day-to-day oversight.\footnote{The SEC has implemented a program of this nature called Public Alert: Unregistered Soliciting Entities (PAUSE).}

323. Undoubtedly, the existence of an alert system, together with the customers’ assistance, may facilitate that authorized financial intermediaries decide, as a precautionary measure, to abstain holding commercial relationships with firms or individuals that allegedly conduct irregular activities.

324. To that effect, it is very important to establish that marketing financial intermediation is an exclusive activity of securities brokers as explained in the previous section.

v. Representative Offices and Correspondent Agreements

325. The issue of representative offices and correspondent agreements was explained in sections 3.b.i and 3.b.ii, and some recommendations were made. Additionally, it is important to reconsider the general policy on the marketing of financial institutions established abroad.

326. A recommendation is studying the convenience of agreeing, as a general rule, that the only means for marketing a financial institution established abroad in Colombia is through representative offices and correspondent agreements, regardless of their origin and the features of their products. The foregoing, without prejudice of what has been negotiated as to national treatment in free trade agreements.

327. Advertising and promotion through representative offices or correspondent agreements should only be authorized to firms from recognized jurisdictions.

328. Services marketed by financial institutions established abroad should meet the standards of like services offered by domestic financial institutions in accordance with the domestic regulation. Otherwise, the opportunity of a regulatory arbitrage is created at the expense of domestic financial institutions. Likewise, it is unreasonable to prohibit domestic financial institutions from offering given products with given characteristics and risks, while permitting that financial institutions established abroad market such products. An example is foreign exchange margin accounts. It is unreasonable that domestic financial institutions cannot offer this product while the product can be marketed by representative offices or through correspondent agreements.

329. Finally, as pointed out in section 4, it is worth reviewing the regulation to ensure that products marketed by representative offices or through correspondent agreements are subject to like standards established for domestic financial intermediaries.
6. Conclusions

330. The global financial architecture is in process of being restructured as a consequence of the largest international crisis since the early 1930s. The impact on Colombia has been moderate, mainly because of the financial system soundness, which did not resort to significant credit restrictions as it occurred in most developed countries.

331. A number of facts arose from the huge liquidity and macroeconomic imbalances in developed economies between the early 1990s and mid-2007, which originated the crisis. From the optic of financial markets, financial innovation was not adequately accompanied by regulation and oversight, which led to underestimating risks and leverage incentives. Further, the procyclical effects of prudential regulation magnified the economic cycle during the boom and badly affected the restoration of credit channels, despite the measures adopted by developed economies.

332. For financial institutions in developed economies changes have been recommended in the management of lending activities during the expansion stage of the cycle and in the transformation of credit-risk into market-risk through securitization and improved transparency of those products. The practice of internal control through qualitative analysis has been highlighted as a mechanism to limit excessive risk-taking. The need of having check and balances in the structure of corporate governance has been emphasized.

333. A recommendation at global level regarding the regulatory structure, is conducting processes of macroprudential oversight to safeguard the financial system stability. This entails coordination between the financial overseer and the monetary authority, as well as the introduction of countercyclical cushions under the prudential regulation.

334. The need of conducting consolidated oversight has been recommended. This entails the financial overseer independence as well as the need of endowing the overseer with all tools needed to collect information regarding risks in the financial system at large. The overseer should have capacity to observe the risks and financial soundness of international conglomerates that badly affect financial institutions subject to oversight in Colombia.

335. The methodological difficulties embedded in the process of risk rating that led to AAA rating over a high proportion of structured products, were explained. The conflicts of interests derived from the income structure of rating agencies which also provide advising services, has been highlighted by the literature as an accelerator of the crisis. Yet, there is no consensus on how to deal with this problem. It has been proven that objectivity and independence of rating agencies failed vis-à-vis the confidence of investors and regulators. Therefore, the credibility of rating agencies has been seriously damaged. Some international proposals point that regulation should rely as little as possible on the use of ratings.

336. Self-regulation through independent external bodies provides additional protection for investors and improves the integrity standards of the market. Coordination between self-regulatory bodies and government regulators, together with the oversight exercised over the former, raises the standards. The crisis has sparked criticism against deregulation models whereby financial institutions should independently establish their own regulation. In contrast, the self-regulation “external-regulated” model which implementation supplements the government task has not been criticized. Findings on the analysis of regulatory structures have stressed the appropriateness of this model.

337. Larger efforts are needed to fight against the irregular phenomenon of taking deposits from the public. In a number of countries the crisis evidenced fraudulent innovations that for many years remained unnoticed by the authorities. This undermined the investors’ confidence and raised questions as to the regulators’ capacity in a number of jurisdictions to safeguard public
savings. There are a number of proposals addressed to protect financial consumers and investors.

338. In Colombia the impact on the economy occurred on the real sector. The productive sector has been badly affected by the reduction of external demand through export reductions, decrease on foreign investment, and reduction of foreign remittances. However, this document does not focus on those issues.

339. Contagion of the financial sector has been minimal thanks to the macroprudential oversight by the Finance Superintendency of Colombia (Colombian overseer) over the financial industry and the prudent monetary policy of Banco de la República (Central Bank). Colombia’s regulation on risk management follows high standards and has been enhanced through the requirement of countercyclical provisions and strict requirements for credit origination.

340. Those factors have positively contributed to limit the effects of the external shock and, therefore, there are no elements to support the need of introducing major adjustments to the regulatory and oversight structure in Colombia. In any case, this structure may be strengthened by granting more independence to the SFC and by broadening its powers with respect to financial conglomerates. Worth is revisiting initiatives such as giving a fix term to the financial superintendent, providing him/her with legal support when sued for the adoption of legitimate measures in discharging his/her responsibilities, and the possibility that the SFC collects information from financial conglomerates.

341. Similarly to developed economies, in Colombia has existed the phenomenon of fraudulent financial innovation with negative social repercussions. There are a number of proposals to strengthen the actions by the authorities to prevent unlawful utilization of funds from the public. In the international scenario, enhancing the protection of financial consumers and investors has been proposed, and, partly, so has been done in the Colombian financial reform.

342. Those elements of the regulatory structure that might be strengthened to prevent unlawful activities should be reviewed. Reviewing and updating the definition of massively and regularly taking deposits from the public has been suggested to ensure that it is compatible with the principle of safeguarding the public interest as mentioned in the Constitution, in Law 964 of 2005 and in Decree 4333 of 2008. Those fungible assets technically complying with the definition of security, but that given their nature and liquidity may be used as an alternative of investment or speculation for the purpose of obtaining financial returns, should also be oversight. Offering services to the public to facilitate or conduct transactions with financial assets, including securities, should be considered financial intermediation.

343. The regulation regarding representative offices and correspondent agreements should be reviewed in light of the financial crisis, to the extent that confidence by extension is being subject to criticism internationally and has become an indirect transmission mechanism of crisis into the Colombian financial system.
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The table below summarizes the main recommendations made regarding regulation, together with a comparison with the current Colombian regulation. The table includes recommendations from the G30\textsuperscript{97}, the European Union through the High Level Group on Financial Supervision led by Jacques de Larosière\textsuperscript{98}, the FSA\textsuperscript{99}, the IMF\textsuperscript{100}, and the Department of the Treasury of the United States\textsuperscript{101}. Recommendations relating the global supervisory framework, international cooperation and functioning of multilateral organizations are not included. Neither are included recommendations applicable only to the American regulatory structure such as the elimination of oversight programs from the SEC, the creation of new agencies (the national bank overseer, the consumer protection financial agency, and the national insurance overseer), and modifications to schemes of financial consumer protection.

The following are topics addressed by the recommendations:

- Prudential Regulation
- Regulatory Capital
- Liquidity Risk
- Risk Rating Agencies
- Origination Standards
- Remuneration Schemes
- Internal Control Systems
- Boards of directors
- Pricing
- Credit Derivatives
- Macropudential Oversight

<table>
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<th>Recommendations</th>
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<th>Recommendations vis-à-vis Colombian regulation</th>
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<tbody>
<tr>
<td>1. Prudential Regulation</td>
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<td>2. Regulatory Capital</td>
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<tr>
<td>- Increase capital</td>
<td>Larosière Group</td>
<td>In 2008 the prudential</td>
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\textsuperscript{98} The Larosière Group. The High Level Group for Financial Supervision in the European Union Report. 25 February 2009
\textsuperscript{100} International Monetary Fund. Initial Lessons from the Crisis. 6 February 2009
requirements in general, and, in particular, treasury books' capital

- Reduce procyclical capital requirements and introduce countercyclical provisions.
- Improve capital quality (exclude hybrid capital)
- Incorporate all systemic and institutional risks to be reflected on capital requirements

- Limit leveraging to prevent excessive asset growth
- Introduce regulation regarding investment instruments off balance

3. Liquidity Risk

- More demanding regulation on liquidity risks are required.
- Improve oversight standards for the liquidity risks management

4. Risk Rating Agencies

- Overseeing the corporate governance structure and the management of conflicts of interests.

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<th>3. Liquidity Risk</th>
<th>4. Risk Rating Agencies</th>
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<tr>
<td>Larosière Group (recommendation 1).</td>
<td>Larosière Group (recommendation 3).</td>
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<tr>
<td>G30 and Steering Committee (recommendation 11).</td>
<td>IMF: Initial lessons from the crisis (Market</td>
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</table>

There are leverage limits for Repos of stockbrokers and assets managed through collective investment. In Colombia there is no regulation on this regard.

The system for liquidity risk management is in force since April 2009 (CE 18 of 2008).

Decree 1076 of 2007 and Resolution 2167 of 2006 of the SFC raised the regulatory standards regarding corporate governance and independence of rating agencies. The provision of advising services has been amended. Chapter XXI of Basic Accounting and Financial Circular (CBCF) of the SFC Chapter II of CBCF introduced countercyclical provisions.

Basic net worth of financial institutions does not include hybrid instruments.

The SFC observes the risks and requires minimum capital for all formal actors in the financial market. (Decree 4327 of 2007).
<table>
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<th><strong>5. Origination standards</strong></th>
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<tr>
<td><strong>Relying less on risk ratings for purposes of prudential regulation.</strong></td>
</tr>
<tr>
<td>- G30 and Steering Committee (recommendation 14)</td>
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<tr>
<td>- Despite the fact that there are provisions requiring institutional investors to conduct their own risk analysis, investment regimes hold the notion that investment grade ratings and not institutional investors’ analysis is the mechanism to guarantee securities safety.</td>
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<th><strong>6. Remuneration schemes</strong></th>
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<td><strong>Ratings are a support and not a replacement of investors’ due diligence.</strong></td>
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<th><strong>7. Internal control systems</strong></th>
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<tr>
<td><strong>Origination standards of mortgage loans should be raised in terms of borrower’s debt/guarantee ratio and debt/income ratio</strong></td>
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<tr>
<td>- Decree 145 of 2000 established that housing loans may finance until 70% of the value of the collateral (house purchase price or its appraisal), and that the first installment may not exceed 30% of family income.</td>
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<tr>
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<tr>
<td>- AMV regulation calls for remuneration policies from financial market players in order to handle conflicts of interests, but is silent on incentives resulting from such policies.</td>
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<th><strong>Internal control systems</strong></th>
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<td><strong>The function of internal control and risk management should follow the following</strong></td>
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<td>- External Circular 019 of 2008 of the SFC and AMV regulation require securities brokers to...</td>
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principles: to be independent, to have enough resources, to be executed by the top management, and to avoid reliance on external advise.

- Larosière Group (recommendation 12).
- G30 and Steering Committee (recommendation 9)

**3. Boards of Directors**

- Strengthen boards of directors of financial intermediaries with larger independence and experience
- Ensure that the board of directors conducts a periodical follow-up of the risk profile of the financial institution.

- G30 and Steering Committee (recommendation 9)

- External Circular 29 of 2006 set out the procedure for taking office of top managers of institutions subject to oversight and contemplates the examination of professional skills and ethics of individuals.

**4. Pricing**

- There should be clear regulation on accounting and pricing of structured products and credit derivatives.
- Reviewing the application of the *mark-to-market* principle for liquid assets, given their procyclical nature.

- Larosière Group (recommendation 4).
- G30 and Steering Committee (recommendation 12)

- The accounting model of institutions subject to the SCF oversight is close to international principles, but has the accounting principle of registering economic facts executed and contingent obligations. Basic Accounting and Financial Circular, Resolution 3600 of 1988, Resolution 497 of 2003, etc.
- A draft Decree on price vendors is being worked out.

**5. Credit derivatives**

- Negotiating and registering credit derivatives transactions with authorized systems and conducting settlement through a

- FSA: The Turner Review (required action 18).
- G30 and Steering Committee (recommendation 15)
- US Treasury: Outlines for

- Credit derivative transactions are prohibited except with authorized financial institutions from abroad. (Regulatory
### Macroprudential oversight

| centralized exchange or clearing house | regulatory reform (comprehensive framework of oversight for the OTC derivatives market). US Treasury: Financial Regulatory Reform A new Foundation (recommendation II.B.) | Circular DODM 144 from Banco de la República |

11. **Macroprudential oversight**

- **Existence of a unique body with authority of receiving and analyzing all relevant information to ensure the financial stability and to intervene in case of systemic risks.**

- **There should be an adequate flow of information between microprudential overseers and macroprudential overseers.**

- **FSA: The Turner Review (actions required 21 y 22)**

- **Larosière Group (recommendation 16 and 17)**

- **G30 and Steering Committee (recommendation 7).**


- The Central Bank permanently verifies the stability of the financial system as a whole as prerequisite of price stability fulfillment. This entails the management of the settlement system, the regulation of financial and exchange activities, acting as a lender of last resort and the assessment of systemic risks.

- Those tasks are conducted in conformity with the coordination committee for the follow-up of the financial system (Decree 1044 of 2003). The financial overseer (resulting from the merger of the banking and the securities superintendencies) has an overall picture of all financial institutions, and of their risks, transactions, financial shape, evolution and perspectives.

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102 Such committee is integrated by: Minister of Finance, Chairman of the Central Bank, the Financial Superintendent and the Fogafin Director.