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Expanding Opportunities for Rural Finance in Colombia

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Abbreviations

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| BAC | Banco Agrario de Colombia (Agricultural Bank of Colombia) | SEDPE | <i>sociedad especializada en depósitos y pagos electrónicos</i> (company specializing in deposits and electronic payments) |
| BMC | Bolsa Mercantil de Colombia (Colombian Agricultural Commodity Exchange) | SES | Superintendencia de Entidades Solidarias (Superintendence of Cooperative Institutions) |
| FAG | Fondo Agropecuario de Garantías (Public Credit Guarantee System) | SFC | Superintendencia Financiera de Colombia (Financial Superinten- dence of Colombia) |
| FINAGRO | Fondo para el Financiamiento del Sector Agropecuario (Financing Fund for Agriculture) | TDA | <i>titulo de desarrollo agropecuario</i> (certif- icate of agricultural development) |
| GDP | gross domestic product | VAT | value-added tax |
| NGO | nongovernmental organization | | |

1. Context

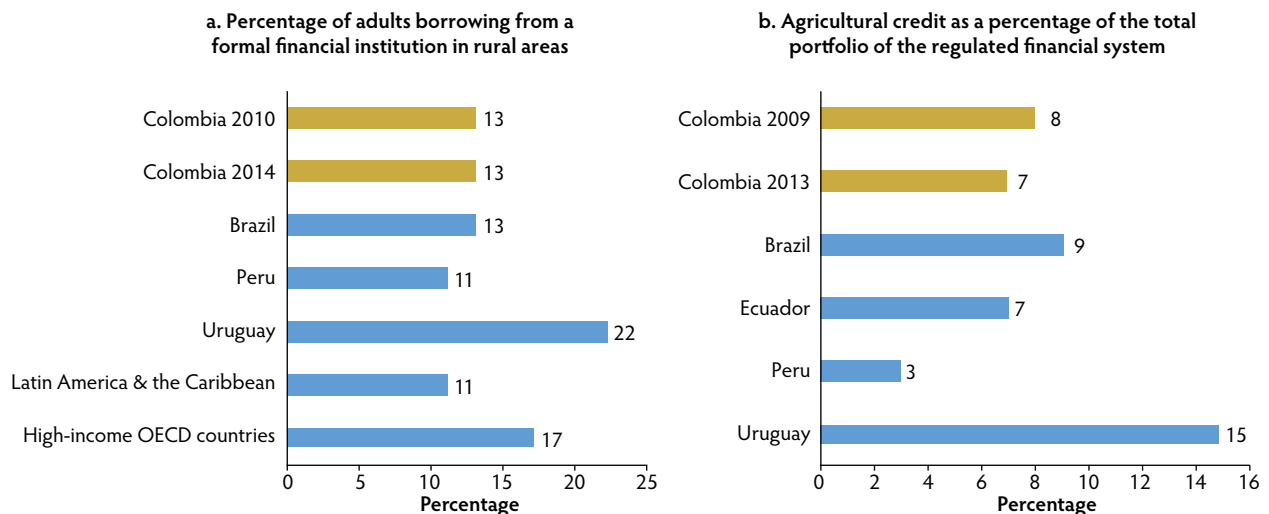
The purpose of this note is to provide policy recommendations to improve access to credit for rural populations and small agricultural producers under financially sustainable schemes.¹ Improving access to finance for these two groups is essential in reducing poverty and inequality, and in supporting a sustainable Colombian peace process for economic development. The ability of agricultural producers and rural households and firms to make long-term investments, take risks, and create stable income streams is shaped by available financial products and services. When financial services are limited, participants in the rural economy may have to forgo valuable investment and income-generating activities and suffer the consequences of irregular consumption activities.

As in much of Latin America, borrowing in rural areas of Colombia remains limited. Almost a quarter (24 percent) of the Colombian population lives in rural areas (World Bank 2014). According to 2014 data collected through the Global Findex survey,² 13 percent of adults living in rural areas

borrowed money from a formal financial institution—the same level as in 2010 (figure 1a). This level of formal rural borrowing is also found in Brazil, and is similar to the average of 11 percent found throughout the Latin America and Caribbean region. It is, however, below the level reported by Findex for Colombians in urban areas (17 percent). Five percent of Colombian rural adults reported borrowing from informal money lenders.

Although the agricultural sector remains an important source of employment, agricultural credit is a small fraction of the commercial credit provided in Colombia. The agricultural sector's share of Colombia's gross domestic product (GDP) has been declining over the past two decades and accounted for 6.7 percent of value added GDP in 2014, having steadily declined over the last two decades. Nonetheless, it employs 16.97 percent of the Colombian population (World Bank 2014). Credit to the agricultural sector represented 7.3 percent of total credit issued by regulated financial institutions in Colombia; this percentage has ranged from 6.8 percent to 7.7 percent between 2002 and 2013 (DNP 2015).

FIGURE 1: International comparison of rural credit



Sources: Global Findex database 2014; Colombian data—National Planning Department and Banco de la Republica/FINAGRO calculations; Latin American data—Trujillo and Navajas 2014.

Note: OECD = Organisation for Economic Co-operation and Development.

The share of agricultural credit in Colombia is below levels observed in other countries in the region. Colombia's agricultural credit as a share of the country's total credit portfolio (7.3 percent) is below the levels observed in other countries in the region (figure 1b), including Brazil (8.5 percent) and Uruguay (14.5 percent) (Trujillo and Navajas 2014). Agricultural credit as a share of agricultural GDP has increased from 11 percent in 2000 to 32 percent in 2013, but is still below the 40 percent ratio of bank credit to GDP. Moreover, most of the increase in agricultural credit has been provided to medium-size and large producers; small producers still face substantial problems in accessing credit. Some estimates suggest that over 75 percent of small agricultural producers lack access to formal credit (Marulanda Consultores 2013).

Inhabitants of urban municipalities have 4.5 times as many physical access points to financial institutions as their rural counterparts. Physical access points include traditional bank branches, automated teller machines (ATMs), and third-party agents (*corresponsales*) such as retail stores or gas stations that execute basic transactions on behalf of a financial institution. Although the number of physical access points has tripled in Colombia since 2009, at the end of 2013, just 27 percent of all bank branches and 18 percent of all *corresponsales* in Colombia were in rural areas. All Colombian municipalities now have some form of financial institution presence, either a branch or a *corresponsale*; the latter, however, tend to serve remote areas and primarily provide payment and collection services rather than credit underwriting.

Colombian commercial banks have limited credit volume in rural areas, concentrating their lending activities on more profitable urban populations. As of end December 2013, 97 percent of the commercial credit portfolio balance, 94 percent of consumer credit, and 94 percent of housing-related credit were provided to urban areas with more than 100,000 inhabitants. Only Colombia's microcredit portfolio is more diversified, with 13 percent in areas with populations of fewer than 10,000 inhabitants, 38 percent in cities of up

to 50,000 inhabitants, and 39 percent in cities with more than 100,000 inhabitants (SFC and Banca de las Oportunidades 2013). A combination of factors—including the lower income level of the rural population, lack of expertise in lending to small agricultural producers, and security concerns in some areas—explain these location patterns.

Substantial opportunity exists to develop microcredit in Colombia. Accounting for only 3 percent of the total credit provided by formal financial institutions as of December 2014 (Banco de la Republica 2015), microcredit is underdeveloped in Colombia. In comparison, microcredit accounts for 4.6 percent, 5.5 percent, and 10.1 percent of total credit in Peru, Mexico, and Ecuador, respectively (Trujillo and Navajas 2014). Although there are approximately 104 microcredit institutions in Colombia, the microcredit sector is highly concentrated in a few large institutions. Although relatively small in outreach and volume in rural areas, two nongovernmental organizations (NGOs) that provided microcredit services—Banca Mia and Fundación Mundo Mujer Popayan—have transformed themselves into commercial banks in order to access cheaper deposit funding. As in other Latin American countries, there is a usury rate on microcredit (52 percent as of March 2015). Colombia's microcredit portfolio expanded by 5.6 percent in 2014; this rate was slower than that for prior years and below the growth rate of the overall credit portfolio (Banco de la Republica 2015).

Deposit warehouses and the Colombian Agricultural Commodity Exchange (Bolsa Mercantil de Colombia, BMC) provide funding for agricultural activities, but they are underdeveloped compared to regional peers and serve medium-size and large producers. Currently there are four deposit warehouses (*almacenes generales de deposito*) supervised by the Financial Superintendence of Colombia (Superintendencia Financiera de Colombia, SFC). They issue certificates of deposit (CDs) and offer credit to producers that store products at the warehouse for more than six months. The BMC offers agricultural producers a platform for funding options through the sale of crops (spot or

forward) and repurchase agreements for securities issued by the deposit warehouse against products stored there. However, its operations are relatively small, with a transaction volume of US\$2 billion in 2014. While this volume is far lower than that observed in other large Latin American countries, this is partly due to the fact that Colombia does not have a futures market and that other countries have a more large-scale, export-oriented agricultural sector (Arias and Lamas 2012). The BMC is mostly used by producers and sellers of agricultural products to register their sales receipts to defer tax payments. Transaction costs, lack of scale, and lack of information impede its use by small producers.

Colombia has a relatively developed insurance sector compared to other Latin American countries, but agricultural insurance has limited outreach and coverage. In 2013, just 1.4 percent of cultivated land was insured despite government subsidies and reduced value-added tax (VAT);³ in comparison, 8 percent of cultivated land is insured in Brazil and 27 percent in Mexico. In Colombia, the main items insured in the primary sector are banana, corn, forest plantations, and rice. The supply of insurance products is expanding; in 2014, three insurance companies offered some type of agricultural insurance product compared to only one company in 2011. Premium values for agricultural insurance nearly tripled between December 2011 and 2014; subsidies covered 67.4 percent of the total cost in 2014 (Fasecolda 2014).

Overall use of mobile- and Internet-based payment financial products remains low in rural Colombia. According to 2014 Findex survey data, just 2 percent of Colombian adults report using “mobile banking,” defined as a mobile platform for making transactions from an account at a financial institution. Use of mobile money products—including DD DEDO, DaviPlata, Ahorro a la Mano, and Transfer—are similarly reported by just 2 percent of adults. Only 6 percent of adults in rural areas report having used the Internet to pay bills or make purchases in the past year. These trends are not markedly different from those in the rest of the region.

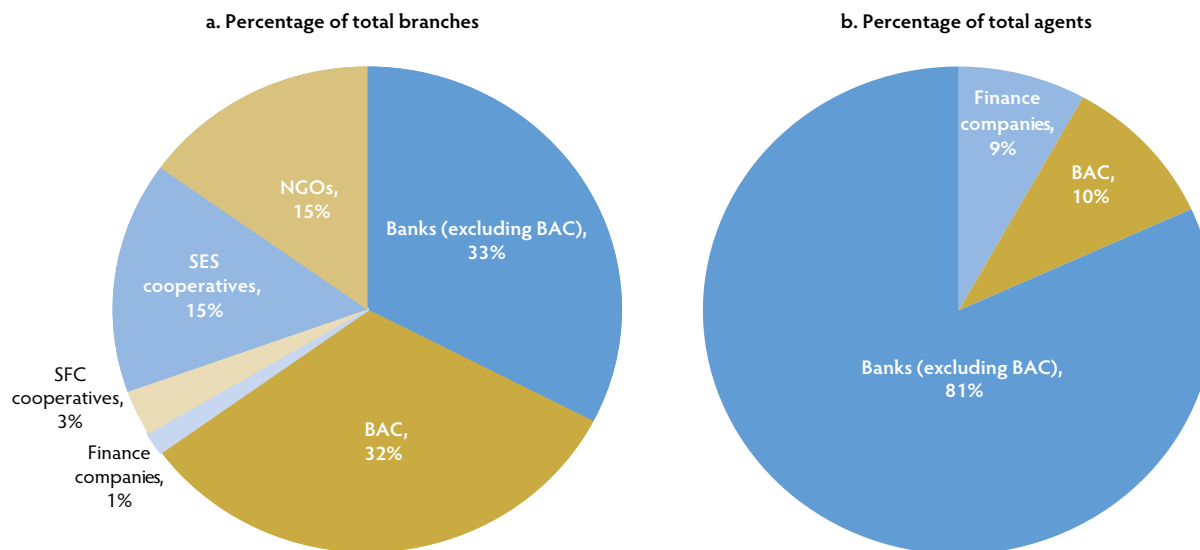
2. Main Challenges

Despite Colombia’s status as a middle-income country with a relatively sophisticated financial sector, its challenges in rural finance echo those of most developing countries. This section outlines five key issues Colombia will need to address related to its supply of financial services, its public policies, and the ability of the general population to access financial services.

Limited participation of private financial institutions lending in rural areas

Although private commercial banks operate most of the agents in rural areas, the Banco Agrario de Colombia (BAC), cooperatives, and NGOs operate most of the branches through which credit is provided. As shown in figures 2a and 2b, private banks and the BAC, the public agricultural development bank of Colombia, have the majority of traditional branches in rural areas (65 percent); private banks also have the vast majority of agents in rural areas (81 percent). Although far more limited in outreach than the banks, the approximately 3,600 member-only cooperatives overseen by the Superintendencia of Cooperative Institutions (Superintendencia de Entidades Solidarias, SES) have 15 percent of the branches in rural areas. Credit NGOs have 51 percent of their branches in rural areas; these entities are not permitted to use agents (SFC and Banca de las Oportunidades 2013).

The BAC is the sole provider of financial services in many rural communities and the dominant source of rural credit for small producers. The BAC is the 15th largest bank in terms of assets and the largest in terms of number of offices (SFC and Banca de las Oportunidades 2013), with 742 branches currently in operation. At least 70 percent of the BAC’s bank loan portfolio must be granted to rural, agriculture, livestock, forest product or fishery (primary sector) activities, or to agribusiness activities. For this reason, 89 percent of BAC branches are located in rural areas, accounting for over 50 percent of all bank offices in those areas (SFC and Banca de las Oportunidades 2013). In

FIGURE 2: Physical presence of financial institutions in rural areas

Source: SFC and Banca de las Oportunidades 2013.

2014, the BAC provided 98 percent of the credit granted by the banking system to small agricultural producers (Marulanda Consultores 2013). At the close of December 2013, 98.8 percent of all microcredit in rural areas was provided by banks (the BAC), 0.8 percent by financing companies, and 0.4 percent by financial cooperatives registered with the SFC (SFC and Banca de las Oportunidades 2013).

Colombia has a broad range of cooperatives that offer different types of financial services, but the system needs to be strengthened to increase

outreach to rural communities. Cooperatives in Colombia are subject to different regulatory regimes depending on whether they operate with non-members and whether they take deposits (table 1). Nonmembership cooperatives are supervised by the SFC; the remainder are under the purview of the SES. Deposit-taking member cooperatives are subject to prudential requirements under regulation, but enforcement is weak given SES resource constraints. In order to increase their outreach to rural areas, cooperatives need to strengthen their corporate governance and improve their efficiency and risk management procedures.

TABLE 1: Types of cooperatives in Colombia

| Does not take deposits | Takes deposits |
|--|--|
| <ul style="list-style-type: none"> Specialized cooperatives without saving accounts (372) "Integral" cooperative without savings accounts (119) Specialized auxiliary institutions (38) Savings and credit cooperatives (27) Representative body (26) Public service cooperatives (15) Economic institutions (12) Undefined (11) | <ul style="list-style-type: none"> Employee funds (1,490) Multi-purpose cooperative without saving accounts (1,222) Associated workers' cooperatives (621) Mutual associations (156) Specialized credit union (144) Multi-purpose credit union with savings and credit (36) "Integral" cooperative with savings and credit accounts (6) Financial cooperatives (5) |

Note: Number of cooperatives are in parentheses. All cooperatives listed offer services to members only, except for financial cooperatives.

Other financial intermediaries such as deposit warehouses and the BMC lack the products and network to effectively serve the agricultural sector in an environment where breach of contract has been prevalent. Deposit warehouse administrators complain about their limited network and strict requirements to obtain credit (UT Econometria Marulanda Consultores 2014). BMC forward products require liquid guarantees on the part of the seller, as contracts tend to be breached when the market price exceeds the forward price. These costs, combined with broker fees, can push forward costs to about 10 percent of the contract value (DNP 2014). Defaults in recent years on some securities transacted by the BMC have affected the institution's standing, even though investors were compensated for their losses by the exchange. Reflecting these and other factors, trading volumes in the BMC have declined dramatically.

Public support programs for rural agricultural credit with perverse incentives

The current system of public support for agricultural rural credit is rather outdated and results in subsidized lending for a small number of producers.⁴ The system includes mandatory investments, credit rate ceilings, and public credit guarantee schemes. Commercial banks, except for the BAC, are obliged to invest a certain percentage of their deposits in certificates of agricultural development (*titulos de desarrollo agropecuario*, TDAs) remunerated at below-market rates. The resources are made available by the Financing Fund for Agriculture (Fondo para el Financiamiento del Sector Agropecuario, FINAGRO), a public second-tier agricultural development bank, to financial institutions for lending to the rural agricultural sector—particularly small producers—at subsidized rates. Banks can also lend under the same conditions directly to the sector instead of investing in TDAs, but interest rate ceilings induce commercial banks to ration agricultural rural credit. Public banks partially fill the gap, but at a cost to the public sector (see discussion [below](#) on partial credit guarantees), and relatively few producers capture subsidies and credit. In addition, small producers can

access several subsidies granted by the Ministry of Agriculture and other organizations to fund investments (for inputs, commercialization, adoption of technologies, etc.), and are often targeted at specific value chains. However, these subsidies are infrequently linked with credit initiatives, leaving recipients less well positioned to leverage public support.

The newly created Rural Microcredit Fund (Fondo de Microcrédito Rural) is a step in the right direction, but will not eliminate distortions.

The Rural Microcredit Fund provides credits for amounts up to 25 times the monthly minimum wage to finance agricultural and other microenterprise activities in rural areas. Rates are determined by the institutions granting the credit, subject to the microcredit usury rate calculated by the SFC. In contrast to other FINAGRO-managed resources, unregulated financial institutions such as credit co-operatives and microcredit institutions will be able to access the Rural Microcredit Fund. Regulations have not yet been issued that would allow the fund to operate with its seed capital—a relatively small Col\$7.4 billion (US\$2.3 million). However, a decree issued in December 2015 (Number 2370) enables FINAGRO to access additional funding sources (such as grants and loans from national, international, and multilateral organizations) to add to this fund.

The sustainability of the current public support system is questionable. Lending to small producers is handled almost exclusively by the BAC, using TDA resources from FINAGRO. However, private banks are reducing their mandatory investments on TDAs (as a share of their deposits) and increasing direct lending to agricultural rural producers—primarily to medium-size and large producers.⁵ Nevertheless, due to the increase in bank deposits, TDA resources are increasing (albeit less than the demand for those resources), straining FINAGRO's solvency.

The public partial credit guarantee fund induces moral hazard and often duplicates coverage provided by agricultural insurance products. FINAGRO administers the Public

Credit Guarantee System (Fondo Agropecuario de Garantías, FAG). About 97 percent of FAG resources provide guarantees to small producers' credit; this is granted mostly by the BAC, a public entity. In many cases, these guarantees are complemented by additional public credit guarantees provided by subnational governments. This system has reduced incentives for proper credit risk assessment and monitoring by the BAC. In addition, borrowers are aware that their credits are covered by a guarantee—which is misunderstood as insurance—further affecting the payment culture and reducing the demand for agricultural insurance. Default rates in credits guaranteed by the FAG reached 6 percent in 2014. As fees for FAG guarantees are subsidized and do not cover expected losses, the fund is depleting its capital, despite its annual allocation of 25 percent of FINAGRO's earnings.

The FAG needs reform beyond the recently introduced administrative reforms. A reform of the FAG introduced in 2014 will prevent use of FAG resources with other credit guarantees and reduce access to resources for institutions with poorly performing portfolios. It will also facilitate guarantee collection and streamline administrative procedures. However, it will not reduce moral hazard behavior on the part of the borrower, and it remains to be seen if the changes will promote financial sustainability.

The BAC has enormous potential to increase financial service penetration in rural areas given its branch network and low funding costs, but lacks incentives to innovate and largely operates as a government development agency. The BAC is primarily located in rural areas largely underserved by financial providers. Lack of competition provides access to cheap funding resources through customer deposits. In addition, all judicial deposits have to be placed in the BAC;⁶ the bank also has access to inexpensive FINAGRO funds, of which it is the largest user. However, the BAC's securities investments amount to about 46 percent of its total assets, which is well in excess of the average for all private banks (18 percent). Moreover, virtually all the BAC's lending portfolio is covered by credit guarantees, reducing its incentive for effective asset

liability management. The BAC largely limits itself to lending at subsidized rates (particularly for small producers) against guarantees with FINAGRO funds and investing in government securities deposits for which it does not compete. Substantial opportunities for BAC improvement exist in the areas of risk management and corporate governance.

Lack of agricultural insurance to support risk management and facilitate access to credit

Compensation provided with fiscal resources to producers in catastrophic events and FAG coverage limit demand for agricultural insurance. Natural disasters are the second largest source of contingent liabilities in Colombia, with annual losses expected of approximately US\$490 million, or 0.7 percent of the national budget (World Bank 2013). Yet catastrophic risk management products are still relatively limited in Colombia. The government spends substantial resources on payouts after disasters rather than on financial products to mitigate and transfer risk before disasters. As discussed earlier, the FAG provides coverage for credit losses, including in the event of crop losses due to climate-related events. Thus, banks do not have the incentive to request that borrowers purchase agricultural insurance, and borrowers mistake the credit guarantee (which does not eliminate obligation of repayment) for insurance.

Developing the supply of agricultural insurance requires government support through the provision of public goods and services. There is room for improvement in the collection, processing, and availability of agroclimatic and price data; and development of accessible information systems related to weather, prices, and agricultural yields. The relevant data are not yet provided systematically, and agricultural industry groups often have useful historical series on costs, yields, and performance that are not captured centrally or available publicly. The fragmentation of data on weather, agricultural production costs, and yields impedes the proper design and pricing of insurance products. Additionally, comprehensive investments are

needed in irrigation, gutters, reservoirs, and other public infrastructure that mitigate the impact of climate events.

The Directorate of Finance and Risk in the Ministry of Agriculture has insufficient staff for analysis. The directorate is thinly staffed to fulfill an ambitious mandate, and currently staff are primarily focused on supervising agricultural credit and insurance subsidies. Very few human resources are dedicated to work related to risk analysis.

Limited range of assets used as collateral

Legal uncertainty regarding land ownership restricts access to finance, especially for medium-size and large agricultural producers which are more likely to receive loans against immovable collateral. Many rural borrowers do not own the land on which they grow crops. Even when they do own the land, they may have already mortgaged the land to finance its acquisition. In either case, the borrower cannot use the land as collateral to finance its agricultural activities. Moreover, even in cases where the farmer has possession of and rights to the land, the land tenure and titling requirements may be inadequate for financial institutions—which consider real estate property unacceptable due to an absence of effective land titling and a lack of clear definition in the legislation and regulations. In such cases, gathering documentation that guarantees the property or rental agreement can be one of the most time-consuming aspects of obtaining credit in rural areas. Rural clients often must travel to regional registry offices to gain access to the required documentation.

Movable collateral reform has great potential to unlock credit for rural micro, small, and medium-size enterprises, but is not yet being used to its full potential. Most assets used as collateral by rural producers to secure a loan are movable property. In the past, the use of movable assets was limited due to an antiquated legal framework. The new Colombian secured transactions law, effective March 2014, changed the manner in which security interests in agricultural goods are created

and recorded. Under the new law, rural producers may use present and future goods as collateral for a loan, including farm equipment, crops, livestock, and their proceeds. Once the goods are in transit, are on deposit, or have been sold, rural producers may use documents of title, deposit receipts, accounts receivable, or deposit accounts as security for the original loan; for new disbursement under the loan or line of credit; or to secure an entirely new obligation.

Although the new secured transactions law permits the borrower to finance its entire business/agricultural cycle, banks are only accepting vehicles as movable collateral. And 2015 data from Confecamaras, the Colombian network of chambers of commerce, show that less than 1 percent of the 1.5 million guarantees registered are for an activity supporting agriculture or livestock. Most of the collateral registered are vehicles, which were already being used to secure loans and thus are not triggering much new lending.

Uncertainty exists regarding the enforcement system in case of default, because it has not yet been tested in court. Although the recent reform will enable extrajudicial execution of collateral once it is fully implemented, this process could be challenged in court; as such, it does not yet have the confidence of the financial industry. Traditional collateral enforcement remains challenging in both urban and rural areas. Doing Business data for 2014 show that legal enforcement of collateral takes an average of 1,288 days in Bogota.⁷ Sub-national Doing Business data available from 2010 show a similarly lengthy period needed to execute contracts in smaller cities such as Pasto, taking up to 1,410 days. Issues of violence, drugs, and cost of traveling to physically isolated places further impede the execution of collateral.

Limited credit history and financial education of the rural population

Given the low penetration of mobile- and Internet-based payments in rural Colombia, nearly all bills are paid in cash. Findex data for 2014 show

that 99 percent of utility payments were made using cash and just 1 percent through a financial institution, inhibiting the creation of a credit history for much of the population. Just 6 percent of rural adults report having used the Internet to pay bills or make purchases in the past year. The prevalence of cash-based payments in rural areas reduces the information available to develop scoring models and other tools to access credit. A new framework designed for companies specializing in deposits and electronic payments (*sociedades especializadas en depósitos y pagos electrónicos*, SEDPEs) is expected to facilitate financial transactions. However, even with the draft regulation,⁸ SEDPEs are not in a position to provide a full range of transactional services (such as payroll) under equivalent conditions to those for other financial institutions due to distortions produced by the financial transactions tax (*gravamen a los movimientos financieros*, GMF). This tax applies to both banks and SEDPEs, but the latter are required to move money out of the wholesale SEDPE system in order to use it for anything else (payroll, for example), constituting an additional taxable step banks are not obligated to take.

Deficiencies in the financial capabilities of the Colombian population hamper demand for financial services and decision making on financial products. In addition to being less likely to use certain financial products, those who live in rural areas are, according to data from the 2012 World Bank–Government of Colombia Financial Capability Survey, much less likely to engage in detailed financial planning behaviors than those who live in urban areas: 44 percent versus 62 percent (Reddy, Bruhn, and Tan 2013). Rural residents had slightly weaker skills in basic numeracy, less understanding of the time value of money, and were less able to calculate simple and compound interest rates. Only 24 percent of rural respondents reported being taught by someone (a parent, relative, teacher, etc.) to manage their money as opposed to 36 percent of urban respondents. And a 2015 survey of micro, small, and medium-size enterprises found self-exclusion to be the main reason cited for not utilizing formal credit (Banca de las Oportunidades and SFC 2015).

Geographic dispersion, long distances, and low population density increase the costs of traditional financial education in rural areas. Although the youth population can be taught financial education in schools, the cost of providing training to adults in a formal classroom environment is prohibitive, particularly in rural areas. Technological advances could be harnessed to provide financial education in a cost-effective manner.

3. Recommendations

Policy recommendations to address the challenges detailed in this section are described below and summarized in table 2 on [p. 16](#).

Develop a vibrant ecosystem of private financial institutions lending in rural areas

Promote the transformation of rural cooperatives into a highly integrated federated network that operates as a rural cooperative bank system and is regulated prudentially by the SFC. Financial authorities could identify cooperative institutions, or an association of cooperative institutions, with a strong rural presence that share a common vision and willingness to associate with other institutions. The ultimate goal would be to establish an organization like the Dutch Rabobank or the Brazilian Sicredi network. Box 1 on [p. 10](#) describes different models of government support for creating financial cooperative networks.

Establish a program to support the transformation of nonregulated institutions into prudentially regulated ones. Currently, there are no public programs to support the transformation of credit cooperatives or microfinance institutions into credit and savings cooperatives. Banca de las Oportunidades only works with regulated institutions. The Rural Microcredit Fund managed by FINAGRO could be a useful tool in this regard if granted sufficient budget for technical assistance activities to these institutions to obtain borrowing accreditation. FINAGRO could also look into developing a technological platform for use with these

institutions. The BAC could provide funding on a second-tier basis to institutions receiving technical assistance with a view to supporting their expansion.

Provide regulatory incentives to the transformation of institutions supervised by the SFC.

To ensure overall financial stability, particularly within the cooperatives sector, credit cooperatives exceeding a certain asset size should be supervised by the SFC. Currently, some credit cooperatives supervised by the SES are larger than the small banks subject to the stricter regimen of SFC supervision. While these cooperatives only take resources from members and not from the public, the distinction between a depositor and a member is not always clear to the public. At a minimum, an auxiliary supervisory advisory model could be designed under which the SFC supervises cooperatives on behalf of the SES, with standards in line with those applying to banks. Concurrently, the deposit insurance coverage for these cooperatives could be increased to the same level as for banks.⁹

Improve the range and quality of services provided by the BMC, including attracting noted international investors.

Initially, the BMC could concentrate its efforts on developing deeper spot and forward markets before venturing into the development of new products. To that end, the BMC should expand its commercialization efforts. To reduce broker fees on spot contracts, it could consider creating a license for brokers that do not deal with financial products that has lower capital requirements and is harmonized with the requirements of regional peers. The BMC could also explore replacing current liquid guarantees on forward contracts with future crops registered in the movable collateral registry or other movable guarantees, or an even more flexible approach in which the transacting parties mutually agree on acceptable guarantees. As these markets deepen and trading and BMC profitability increase, the situation could attract international operators and noted investors; these could subsequently transfer know-how and support the development of derivative products.

Increase the effectiveness of public support programs for rural agricultural credit

Interest rate ceilings for small agricultural producers should be phased out and substituted with interest rate subsidies to financial institutions or an increase in mandatory TDA investments. Interest rate ceilings contribute to the current market equilibrium in which few producers get loans at low rates, leaving most of the segment underserved. To provide incentives for private financial institutions to service the segment, these ceilings need to be removed progressively. It is important to ensure that increases in rates are not passed onto the final borrower—and/or that they are accompanied by an increase in the lending supply to the sector—so as to secure political and social support of these reforms.

Introducing a subsidy in lieu of interest rate ceilings for institutions that decide to service the segment would create incentives for private financial institutions to increase the supply of credit. The subsidies could be allocated through auctions depending on the rate charged to the final borrowers. Alternatively, and in the absence of fiscal space to introduce subsidies, mandatory investments on TDAs for lending to small producers could be increased progressively, allocated by FINAGRO through a system of reverse auctions. To help new players interested in lending to the segment access those resources, FINAGRO should set the same limits on lending to credit and savings cooperatives as apply to other public banks.¹⁰ Consideration should also be given to allowing FINAGRO to channel resources through microfinance and other nonregulated institutions, as it gains experience in operating with these intermediaries through its Rural Microcredit Fund.

Undertake an integral reform of the FAG, migrating it toward a portfolio guarantee scheme and auction-based pricing.

Generous FAG coverage limits the incentives for the BAC to conduct effective credit risk assessment and risk pricing even if interest rate ceilings were removed. Moreover,

BOX 1: Government support for the creation of financial cooperative networks

Financial cooperatives have adopted different integrative models around the world with the goal of achieving economies of scale that will support viability while offering a wide range of services to customers. Adopted structures range from the **atomized-competitive network model** to the **federated network model**. In the first model, integration is largely limited to shared publicity, lobbying, and representation. Resources are sometimes shared but without centralization. In the federated network model, resources and decisions are centralized, and the customer sees the network as a single entity. The federated network model of organization offers greater advantages to its members than the atomized-competitive model, and most federated financial cooperative networks outperform atomized-competitive networks in terms of stability, financial efficiency, and market penetration (DID 2005). In fact, Rabobank and Desjardins—both federated networks—not only outperform atomized-competitive networks but also commercial banks.

In the federated model, the cooperatives **share resources** and access to support (back office) services provided by a second-tier institution (the federation) which is owned by them. Integration into a network also facilitates **standardization** of operational systems (such as accounting and data processing), policies and norms, products, and the institutional image. Standardization contributes to better performance by promoting comparison among base units. In a federated network, **contractual solidarity binds members** on issues such as the regional area of operation, member size, dues, group borrowing, and cross guarantees. The most integrated networks such as Rabobank appear to be a unified institution.

Federated networks **strengthen governance of their members through internal regulations and strategies**. Network structure is characterized by democratic representation and centralized authority by an apex organization whose roles and responsibilities complement those of the base units. The federation has a surveillance function over its members, and there are established mechanisms for affiliation and disaffiliation. The federation trains, supervises, advises, develops products, and ensures monitoring of the base units. Finally, a federated network of cooperatives often has **shared ownership**

(continued)

as rates are liberalized, more players could access FAG guarantees. To limit moral hazard behavior on the part of the borrower and the lender, the FAG should be reformed. Migration toward a scheme under which portfolios of loans—rather than individual loans—to small producers are covered by the guarantee mitigates moral hazard on the part of the borrower. Allocating guarantees through auctions on the basis of the coverage requested and interest rate applied to the borrower would provide incentives to institutions to improve risk assessment and credit collection. For example, Chile's Guarantee Fund for Small Enterprises (Fondo de Garantía

para los Pequeños Empresarios, FOGAPE) auctions guarantees at a fixed cost, letting lenders bid based on the coverage ratio. Mexico's development bank, Nacional Financiera (Nafinsa), which supports small and medium-size enterprises, auctions guarantees under the portfolio approach model.¹¹

FAG coverage should also be modified to incentive the use of mobile guarantees and agricultural insurance. For small producers, the current guarantee coverage could be modified to include only loan cancellation in the face of severe adverse weather or catastrophic events that are clearly defined ex

BOX 1: Government support for the creation of financial cooperative networks *(continued)*

in a central agency, a security fund, an insurance firm, or a brokerage that generate products, services, or other inputs which are delivered to members at the base level.

Governments in many countries have actively supported the formation of cooperative networks to foster financial stability and/or maintain financial inclusion in remote areas typically served by small rural providers. In many cases, governments have raised minimum capital requirements for cooperatives to force mergers in the sector with a view to reach scale. They have also introduced differentiated capital requirements for cooperatives in a federated network. For example, in Brazil, the minimum capital requirement for cooperatives is 13 percent, compared to 11 percent for cooperatives in a federated network. Examples of financial cooperative networks created by governments and multilateral donors include the following.

Albania. In the late 1990s, Albanian authorities, through a World Bank loan, supported the creation, training, and monitoring of 92 operationally sustainable financial cooperatives and their organization into a network. They also created a second-tier institution owned by the cooperatives—the Albanian Union of Savings and Credit Associations—to provide services to the network, and developed network procedures, governance arrangements, and methodologies. The union’s main functions were to train its members, provide funding, and collect and monitor data on behalf of the official supervisor.

Austria. In the 1890s, the Austrian government took measures to support the creation of a three-tier cooperative network, Raiffeisen Zentralbank.

Moldova. A World Bank loan financed the creation of rural financial cooperatives and a federation of such cooperatives in Moldova in the early 2000s.

The Netherlands. In the 1890s, the Dutch government supported the creation of credit cooperatives through subsidies, later changing the policy to provide subsidies to two apex cooperative institutions; these later became Rabobank.

ante. This would ensure that financial institutions have only covered tail risks, providing incentives to use mobile guarantees. On the other hand, for medium-size and large producers, the guarantee could cover only risks other than those arising from weather or catastrophic events, inducing banks to require agricultural insurance to access credit. Authorities could consider subsidizing part of the insurance premium, as is the case in Mexico for certain types of credits.

Capitalize FINAGRO to increase its ability to catalyze resources to the rural sector. This

would allow FINAGRO to play a role in mobilizing capital market resources similar to that of the National Development Finance Institution (Financiera de Desarrollo Nacional) for infrastructure. FINAGRO’s capital is already close to the 10 percent minimum capital requirement currently in place for banks in Colombia. An increase in the mandatory TDA investments as proposed above may not be intermediated by FINAGRO, given current capital constraints. Moreover, with additional capital, FINAGRO could expand its range of products to include enhancements to securitizations of agricultural or microrural credits.

Through securitization, capital market resources could be mobilized to introduce competition to banks and lower interest rates for small producers. And, by providing guarantees to the final investor as opposed to the credit originator, moral hazard could be reduced provided the originator retains the equity tranche of the transaction. Securitization would also allow expanded credit channels to small producers by alleviating capital constraints of credit cooperatives and other small niche players operating in the segment, who would obtain capital relief through portfolio securitization. The World Bank, in a project supported by the Swiss Economic Cooperation and Development Organization (SECO), is working with FINAGRO on piloting one such transaction.

The BAC needs modernization, which could be supported by new investors with expertise in the sector. The BAC's corporate governance; credit origination, credit recovery, and second-tier services; and portfolio and market risk management offer substantial opportunities for improvement. The BAC is currently receiving technical assistance in those areas from foreign institutions with substantial expertise in rural lending. However, reform of current agricultural credit policies in the dimensions discussed on [p. 5](#) is needed to provide adequate incentives to the BAC, including by facilitating the entrance of capital from investors. In the context of the current peace process, the experience of Guatemala's Banrural could provide a blueprint for the BAC that would enable it to maintain its rural character and continue its service to marginalized segments while ensuring its financial sustainability (box 2 on [p. 14](#)).

Create a technical committee to improve coordination and cooperation between government entities with competencies in rural and agricultural financing. Several public institutions in Colombia have rural financing responsibilities. While the heads of many of these institutions meet as members of the National Agricultural Credit Commission (Comisión Nacional De Crédito Agropecuario), meetings at the technical level to explain ongoing initiatives and strategies do not occur

regularly. Conducting technical meetings could improve coordination of public and private efforts at earlier stages.¹²

Develop agricultural insurance to improve risk management and facilitate access to credit

In addition to reforming the FAG as discussed on [p. 9](#), the public sector could support the development of agricultural insurance products by developing an improved agricultural information system. In some cases, producer associations and other industry groups have data series on yields and prices for particular crops that could be aggregated with public data for a more complete picture of agricultural performance. Efforts under way by FINAGRO to provide a central clearinghouse for data on agricultural insurance are promising. Uruguay's National System for Agricultural Information (Sistema Nacional de Información Agropecuaria) offers a good model in this regard, with a strong regulatory framework to access and secure information, established protocols for inter-institutional coordination, political support to achieve inter-institutional cooperation, and financial support from the national government.

Improve public sector risk mitigation strategies by adjusting subsidies for insurance. High insurance prices prevent certain markets from being insured. To reduce these prices, resources should be shifted from subsidies to producers to the provision of public goods that mitigate risks such as drains, reservoirs, and irrigation systems. To further improve the market, a public-private partnership on agricultural insurance should be established, which could provide training to both insurance companies and regulators on issues related to losses and reserves. Also, to enhance the capabilities of the Directorate of Finance and Risk in the Ministry of Agriculture, staff skilled in risk mapping, probability mapping, and agroecological zoning should be hired or trained.

Make catastrophic insurance available to increase Colombia's financial resilience and

BOX 2: Privatizing agricultural development banks: the case of Banrural, Guatemala

Banrural S.A. was created in 1998 with the restructuring of the Guatemalan National Agricultural Development Bank (Banco Nacional de Desarrollo Agrícola, Bandesa), a state-owned bank with extensive presence in rural areas and 86 percent of its loan portfolio in the agricultural sector. The transformation from Bandesa to Banrural was part of the modernization process of the Guatemalan state and financial system approved by the Guatemalan Congress in 1997 (Alfaro-Gramajo 2003).

Banrural was established as a joint public-private venture, with 30 percent of its capital provided by the state and 70 percent by the private sector (Alfaro and Alfaro 2010). Its ownership structure was designed to facilitate the active participation of civil society groups involved in the rural sector and with a strong social commitment. Its private shareholders include community groups, cooperatives, and organizations. The bank focuses on providing a wide range of financial services that facilitate productive social, investment, and consumer activities in rural areas, as well as servicing social sectors not traditionally served by the financial system (for example, indigenous groups).

Banrural seeks to foster economic activity in rural areas of the country in a way that is profitable and sustainable for its shareholders, while maintaining a development objective with an entrepreneurial vision. Today it is Guatemala's most profitable bank, and its second largest bank in terms of assets, valued at US\$5.9 billion at the end of 2014 (Superintendencia de Bancos de Guatemala 2015). The bank relies on an extensive network of agents and has over 900 offices serving more than 5.7 million customers around the country; it has recently expanded to Honduras (Banrural [website](#)).

Banrural offers a diverse array of products, including microenterprise credit, corporate credit, second-tier lending, and international operations, as well as a number of payment services (water, electricity, telephone). First-tier lending is provided by a specialized microfinance unit, which lends through different methodologies including individual loans, solidarity groups, and communal banks. Other loan products are designed for small and medium-size farmers, consumer needs, and housing renovations and expansions.

improve fiscal risk management for supporting the rural sector in catastrophic events. Improving fiscal risk management could provide additional space for some of the reforms proposed in this note. The government should rethink the subsidy to agricultural insurance as a percentage of the premium, and place more of an emphasis on subsidizing the catastrophic layer and focusing on those most vulnerable to natural disasters. A government institution (for example, FINAGRO) could work with the Colombian Federation of Insurance Providers (Federación de Aseguradores Colombianos, Fasecolda) to develop and demonstrate the use of an insurance product to cover

fiscal losses for tail events. Alternatively, the issuance of catastrophe bonds could be explored.¹³

Expand the range of assets eligible as collateral

Explore the feasibility of title insurance. Title insurance protects an owner's or a lender's financial interest in real property against loss due to title defects. It defends against a lawsuit attacking the title, and reimburses the insured for the actual monetary loss incurred up to the amount covered by the policy. Title insurance was developed in the United States in response to deficiencies in the land titling

system.¹⁴ Development of such a product could be explored in Colombia, offering protection on land titles that have reached certain milestones toward establishing property rights. Public resources could offer reinsurance protection to insurers. Title insurance could unleash credit to put such land into production by providing protection of mortgages (box 3 on [p. 16](#)).

Finalize the issuance of decrees and regulations supporting movable collateral reform. Expanding the range of assets that can be used as collateral will be helpful in channeling credit to rural areas, particularly to small rural firms. The decree regulating the enforcement of security interests registered in the movable guarantee registry still needs to be issued. Also, the SFC still has to issue a regulation recognizing movable assets as eligible guarantees and determining the treatment of

the guarantee for provisioning requirements. Regulations for provisions could be developed by determining the expected loss by type of guarantee provided for commercial credit, using international experiences, with a haircut, until local data are available. To gather this information, a field could be included in the movable collateral registry with the liquidation value of the guarantee in the event of credit default.

The BAC could stimulate the use of mobile guarantees by being a first adopter in accepting mobile guarantees other than vehicles. Banks have been resistant to register guarantees other than automobiles, and the BAC could provide a demonstration effect to other financial institutions by using types of guarantees common in rural areas in a way that improves underwriting processes. The BAC may consider issuing partial credit guarantees,

BOX 3: Land transfer and title insurance

Where uncertainty exists over land title due to fraud or error, a legal system can protect either the current (innocent) owner or a previous owner who claims the title. The U.S. system generally awards title to the latter in the event of a legitimate claim. Thus, current owners frequently purchase title insurance to provide indemnification in the event of a loss.

Alternatively, a title system could be structured such that, in the event of a claim, the current owner retains title to the land, and the claimant is indemnified. The Torrens system, which has been used in some U.S. states including Massachusetts and Minnesota, is an example of such a system. Under the Torrens system, current owners register their property with the government, at which time an examination of the title is conducted. If no claims are made, title is declared to reside with the owner against all future claims, and a public fund is established from registration fees to be used to compensate legitimate claimants who subsequently appear.

Miceli and Sirmans (1995) maintain that if land transaction costs are low, both systems are equally efficient; but if they are high due to high notary fees and taxes, the Torrens system is more efficient as it allocates land to who values it more.

Several U.S. states have experimented with the Torrens or other title registration systems at one time or another, but most have retreated to title recording under pressure from title insurers. Llewellyn (2008) notes that one Torrens title on a lot in New York City can render the entire block unavailable for large-scale improvement, as no lender will finance the purchase of such a lot because no New York title insurer will guarantee a Torrens title.

which require that the borrower provide movables as collateral under the new Colombian law. Doing so would allow the BAC to leverage its assets and incentivize the use of the new law. The BAC's pilot efforts would also allow the banking regulator to obtain important information on the functioning of the new system without creating an overall systemic risk for all financial institutions.

Support the increased creditworthiness of the rural population by developing credit histories and improving financial education

Introduce a general value-limit exemption for balance and transaction volume for wholesale e-accounts to incentivize the use of electronic payments. This general exemption, instead of a service line-specific exemption such as the one designed for bill payment collection, would enable SEDPEs to potentially compete with a full range of transactional services—for example, payroll services in rural areas. This change would alleviate regulatory and lobbying efforts that would be required for SEDPEs to provide additional services. It would also level the playing field between SEDPEs and banks, and ideally increase competition for a wider range of services, such as bulk payments, payroll, and business to business (B2B). By so doing, the use of these services among rural populations could be increased, and an alternative credit history for many potential borrowers created. Increased competition from the full participation of SEDPEs is likely to have a positive impact for consumers and fuel innovation and ultimately rural financial inclusion.¹⁵

Increase knowledge of rural youth through school-based financial education. As the Ministry of Education prepares to pilot national school-based financial education programming across several grade levels in Colombia, this presents an

opportunity to strengthen deficiencies in financial planning and financial knowledge that are particularly striking in rural areas. Key competencies and standards defined should include basic financial concepts—such as the time value of money, calculation of interest rates, and portfolio diversification—that are needed in choosing and managing financial products effectively. To improve the pilot's impacts, its effects on key population segments such as rural youth should be rigorously evaluated and the programming adjusted as necessary.

Colombian authorities and other stakeholders could consider scaling up mass media interventions to disseminate key messages related to financial capability. Providing educational content for adults in rural areas can be costly. Numerous countries have provided financial education content to adults through media messaging (radio, *telenovelas*, text messages) as well as through entertainment programming, with the goals of increasing knowledge and promoting cultural change. For example, those who viewed financial education messages on debt management provided through a popular South African soap opera had significantly more financial knowledge and were almost twice as likely as those who did not view the soap opera with its educational messages to borrow from formal sources; they were also less likely to gamble (Berg and Zia 2013). Banca de las Oportunidades has been supporting live events with some financial education content using popular entertainment personalities; it could consider supporting a larger-scale intervention through television or radio. In addition, providing content at teachable moments—when people are seeking information about financial decisions (for example, when borrowing for education or for the purchase of a new home, or when preparing for the birth of a child)—has been shown to have good effects, although these vary based on recipient characteristics (Doi, McKenzie, and Zia 2012).

TABLE 2: Matrix of recommendations

| Development challenge | Recommended policy option | Responsible institution | Time frame | Impact |
|---|--|--|-------------|--------|
| Develop a vibrant ecosystem of private financial institutions lending in rural areas | • Promote the association and transformation of rural cooperatives into a rural cooperative bank prudentially regulated by the SFC | MHCP (in coordination with SES and SFC) | Medium term | High |
| | • Develop a program to support the transformation of nonregulated institutions into prudentially regulated ones including through provision of technical assistance and back office services | FINAGRO, Banca de las Oportunidades MHCP | Medium term | Medium |
| | • Transfer supervision of large cooperatives under the SES to the SFC and equalize deposit insurance coverage between cooperatives and banks | MHCP | Medium term | Medium |
| | • Improve the range and quality of services provided by the BMC including through attracting reputed international investors | BMC, MADR | Short term | Low |
| Increase the effectiveness of public support programs for rural agricultural credit | • Phase out interest rate ceilings for small agricultural producers and replace with interest rate subsidies to financial institutions or an increase in mandatory TDA investments | MHCP, MADR | Short term | High |
| | • Reform the FAG including (i) moving to a portfolio scheme and pricing base auction, (ii) offering credit enhancements on loan securitizations, and (iii) reducing coverage events to avoid duplication with agricultural insurance and incentive mobile guarantees | MHCP, MADR | Short term | High |
| | • Capitalize FINAGRO to support new product development and increased role | MHCP, MADR | Short term | High |
| | • Reform the BAC to improve its performance, including changes in ownership structure | MHCP, MADR | Short term | High |
| | • Create a technical committee to improve coordination and cooperation among public entities | MHCP, MADR | Medium term | Low |
| Develop agricultural insurance to improve risk management and facilitate access to credit | • Reform the FAG as previously discussed | MHCP, MADR | Short term | High |
| | • Adjust the subsidy to agricultural insurance as a percentage of the premium, to place more of an emphasis on subsidizing the catastrophic layer | MHCP, MADR | Medium term | High |
| | • Develop a central clearinghouse of public and private data to improve risk mitigation | FINAGRO | Short term | Medium |
| Expand the range of assets eligible as collateral | • Explore the feasibility of developing a land title insurance product | Fasecolda | Medium term | High |
| | • Finalize the issuance of decrees and regulations supporting movable collateral reform | SFC, MHCP | Short term | High |
| | • Provide a demonstration effect of how movable collateral other than vehicles can be registered | BAC | Medium term | Medium |
| Support the increased creditworthiness of the rural population by developing credit histories and improving financial education | • Provide a general value-limit exemption from the financial transactions tax for all wholesale e-accounts | SFC | Medium term | Low |
| | • Increase financial knowledge of rural youth through school-based financial education | Ministry of Education | Medium term | High |
| | • Promote cultural change related to financial products through mass media messaging, such as entertainment education | Banca de las Oportunidades | Medium term | Medium |

Note: Fasecolda = Colombian Federation of Insurance Providers (Federación de Aseguradores Colombianos), MADR = Ministry of Agriculture and Rural Development (Ministerio de Agricultura Desarrollo Rural); MHCP = Ministry of Finance and Public Credit (Ministerio de Hacienda y Crédito Público).

Notes

- 1 The Colombian statistical authority (Departamento Administrativo Nacional de Estadísticas) defines *rural areas* as having dispersed arrangements of homes and farms and generally lacking the formally named streets, avenues, and public services typically found in urban areas. Colombia defines *small agricultural producers* as individuals whose total assets (including spousal assets) are less than 145 times the monthly minimum wage and are at least 75 percent agricultural, or at least two-thirds of whose income is of agricultural origin.
- 2 Global Findex, <http://www.worldbank.org/en/programs/globalfindex>.
- 3 Government subsidies range from 60 to 80 percent depending on the producer's size and whether it has credit funded by public banks. VAT on insurance premium ranges from 2 to 5 percent, depending on whether the insurance is paid electronically.
- 4 Rural credit as used here refers to *crédito agropecuario rural*, which in Colombia is understood as credit used in the various phases of the production of agriculture, livestock, and fishery goods; their transformation or commercialization; as well as credit for mining, rural tourism, jewelry, and crafts.
- 5 In 1996, 91 percent of agricultural rural credit was granted with TDA resources compared to 26 percent in 2013 (DNP 2014).
- 6 Judicial deposits are those required by judicial order.
- 7 Doing Business, <http://www.doingbusiness.org/data>.
- 8 For the draft SEDPE regulation, see <http://www.urf.gov.co/portal/page/portal/URF/Proyecto-Decreto/2015/Proyecto%20de%20decreto%20Reglamentacion%20SEDPEs.pdf>.
- 9 A recent World Bank technical assistance engagement with the Cooperative Institutions Guarantee Fund (Fondo de Garantías de Entidades Cooperativas, FOGACOOOP) highlighted that there is scope for the deposit insurance fund to increase deposit insurance coverage and eliminate coinsurance.
- 10 Currently, FINAGRO can only lend credit and savings cooperatives up to 10 percent of the given cooperative's capital. Bancóldex, the public bank supporting exporters, can lend up to 10 percent of its capital to each institution. Regulation to address this situation is currently under consideration.
- 11 See OECD (2013, 30) for a description of allocating guarantees through auctions.
- 12 The commission's membership consists of the agricultural minister, the director of the National Planning Department (Departamento Nacional de Planeación), the manager of the Central Bank (Banco de la República), two presidential appointees, and a representative of the financial institutions operating in the agricultural sector. FINAGRO is the commission's technical secretariat.
- 13 Catastrophe bonds transfer the risk of a natural disaster to investors by allowing the issuer to not repay the bond principal if a major natural disaster occurs. The World Bank has developed the MultiCat Program, a bond issuance platform that transfers diversified risk to private investors. Under the program, Mexico issued a four-tranche catastrophe bond (totaling US\$290 million) with a three-year maturity in 2009, which was oversubscribed.
- 14 Title insurance is available in other countries as well—throughout Europe and the Commonwealth, and in Mexico—to U.S. citizens or corporations purchasing property there through U.S. insurance companies.
- 15 Source: Consultative Group to Assist the Poor (CGAP) internal commentary note on SEDPE regulation, May 2015.

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