

ASSESSMENT OF RISK MANAGEMENT AND THE STRATEGIC STRUCTURE WITHIN THE BANK

1. What risk-management guidelines have the Board of Directors and/or the Management Board instituted? (Bear in mind this involves more than financial risk.)

For the Central Bank (Banco de la República), risk management is immersed in every activity in every section and department, and is considered an essential element of daily operations. The Board of Directors, as the monetary, exchange and credit authority, and the Management Board, as the chief administrative authority, set general policy on risk management for the activities of the Central Bank. In this sense, the decision-making process invariably involves an assessment of the different risks to which the institution could be exposed. Decisions to this effect are implemented by the Management Committees¹, which define general guidelines for the areas and branches on how different risks should be managed, primarily those of an operational (image, legal, security, continuity, technological) and financial nature (liquidity, market, credit and systemic).

- ***The Monetary and Exchange Intervention Committee*** is comprised of the Minister of Public Finance and Credit or his delegate, the General Manager, and the full-time members of the Central Bank Board of Directors. Attendance at the meetings may not be delegated, except in the case of the Minister of Public Finance and Credit. The Technical Manager, the Deputy Director of Economic Studies and the Deputy Director of Reserve and Monetary Management are regular guests, but are not members of the Committee.

This committee is responsible for implementing the monetary-policy and exchange decisions adopted by the Board of Directors, in addition to analyzing and dealing with market, credit, liquidity, systemic and operational risks.

- ***The Committee on International Reserves*** sets policy on how the Central Bank is to manage international reserves, and regularly reviews their yield and composition. Its members include the Minister of Public Finance and Credit or his delegate, the full-time members of the Central Bank Board of Directors, and the General Manager. The Technical Manager, the Deputy Director of Reserve and Monetary Management, the Director of the Department of International Reserves, and the General Auditor of the Central Bank or his delegate are regular guests.

Among other duties, this committee assesses and suggests policy guidelines on the make-up of international reserves as concerns the share of certain assets; namely, current account and cash, gold as a portion of international reserves, the investment portfolio, the additional special drawing rights position Colombia is required to maintain with the International Monetary Fund, and the additional position required with the Latin American Reserve Fund, as decided by the member countries.

¹ The Management Committees are set up by the Management Board in accordance with article 41, subsection i) of the Bank's charter. They are technical bodies charged with planning, consultation, recommendation and evaluation. Some are authorized to order spending in an amount determined by the Management Board. For the most part, these committees are comprised of Central Bank officials and eventually outside experts, in order to adopt decisions in the areas where they have jurisdiction or to evaluate the operation of one or more of the areas within the Bank, and to furnish opinions for decision-making.

The Committee on International Reserves also defines investment guidelines for the investment portfolio. This includes the portion managed directly by the Central Bank and the portion assigned to external institutions. It determines criteria on control over credit risk exposure in the selection of security issuers and depository institutions where international reserves can be invested. In addition, it defines criteria on the currencies that comprise the investment portfolio, as well as minimum and maximum exchange risk exposure; criteria for tolerance to market risk originating with volatility in the price of the assets that comprise the investment portfolio, as well as maximum and minimum exposure to this risk; the type of assets and transactions authorized for the management of international reserves; the liquidity requirements for international reserves; and performance goals for risk and yield assessment. It uses this last criterion to evaluate how reserves are being managed.

- ***The Audit Committee*** includes of two members of the Board of Directors, one of whom chairs the Committee. The other members are the Executive Director and the Deputy Director of Banking Operations. The General Auditor, the General Accountant and the Director of the Internal Control Department are regular guests. The latter serves as the secretary of the Committee.

Among other aspects, the Audit Committee is responsible for assessing management of the risks associated with presentation and disclosure of the Bank's financial information. It also monitors aspects that are considered important to the structure and operation of the Central Bank's system for internal control.

- ***The Procurement Committee*** includes the Deputy Administrative Director, who chairs the Committee, the Deputy Director of Industrial and Treasury Management, the Deputy Director of Banking Operations, the Deputy Director of Data Processing, and a delegate appointed by the General Manager. The Deputy Director of Security is a regular guest.

The Procurement Committee implements policies on the contracting, purchase and retirement of the movable property and goods the Bank needs to operate. It also authorizes spending in exercise of the faculties afforded by the Management Board and in accordance with budget approved by the Board of Directors. Among other aspects, the Committee analyzes the operational risks involved in contracting and the risks associated with financial loss and loss of image.

- ***The Continuity Committee*** includes the Executive Director, who is the chairman, the Deputy Director of Banking Operations, the Deputy Director of Data Processing, the Deputy Director of Reserve and Monetary Management, the Deputy Director of Security and the Deputy Managing Director. The General Auditor, the Director of the Planning and Budget Department, and the Director of the Data Processing Protection and Continuity Unit are regular guests. The latter serves as the secretary of the Committee.

Among its duties, the Continuity Committee advises the institution on how to ensure continuity of the essential functions of the Central Bank. In conjunction with the national government and the financial sector, it coordinates the management of systemic risks in the national and international system of payments, and guides the Central Bank on preventing the systemic risks that can occur when information systems are temporarily unavailable.

As part of its analytical duties, the Committee examines aspects or risks associated with the unavailability of services and looks at crisis situations that could occur in different scenarios.

- *The Internal Control System Coordinating Committee- ICSCC* oversees the Central Bank's internal control system and is responsible for assessing its efficiency and effectiveness. It also recommends corrective measures or modifications required to comply with proposed objectives.

The Executive Manager chairs the Committee. The other members include the Deputy Directors of Banking Operations, Industrial and Treasury Management, Data Processing, Management, Cultural Affairs and Security. The General Auditor and the Director of the Internal Control Department are regular guests. The latter serves as the secretary of the Committee.

An analysis of operational risks and controls for processes, projects and/or systems regarded as critical to the Central Bank is presented in the Committee.

- *The Security Committee* provides advice and consulting aimed at securing the institution's property and facilities, as well as the operations and procedures developed in fulfillment of its role as a central bank. The members of the Security Committee include the Executive Director, who is the chairman, the Deputy Managing Director, the Deputy Security Director and three delegates of the General Manager, one of whom is experienced in data processing. The Director of the Protection and Security Department serves as the secretary.
- *The Pension Liability Resource Investment Committee* is comprised of the Executive Director, who is the chairman, the Deputy Director of Banking Operations, the Director of the Operations and Market Development Department (OMDD) and the Director of the External Borrowing Facilities and Holdings Department (EBHD) who acts as the secretary. The General Auditor is a regular guest.

Its main function is to recommend policies on management of the Bank's pension liability resources and to advise the administration on decisions concerning technical and operational management of the portfolio in which these resources are invested. This committee also provides advice on how to address operational and financial risks.

To add to the work of these committees, the Secretary of the Board of Directors and the Legal Department develop activities involving analysis and management of legal risks. As to risks concerning the Bank's image and how they are addressed, the Institutional Communication Department develops internal communication protocols with employees and external protocols with the entities that receive reports from the Central Bank, including public opinion and the financial system.

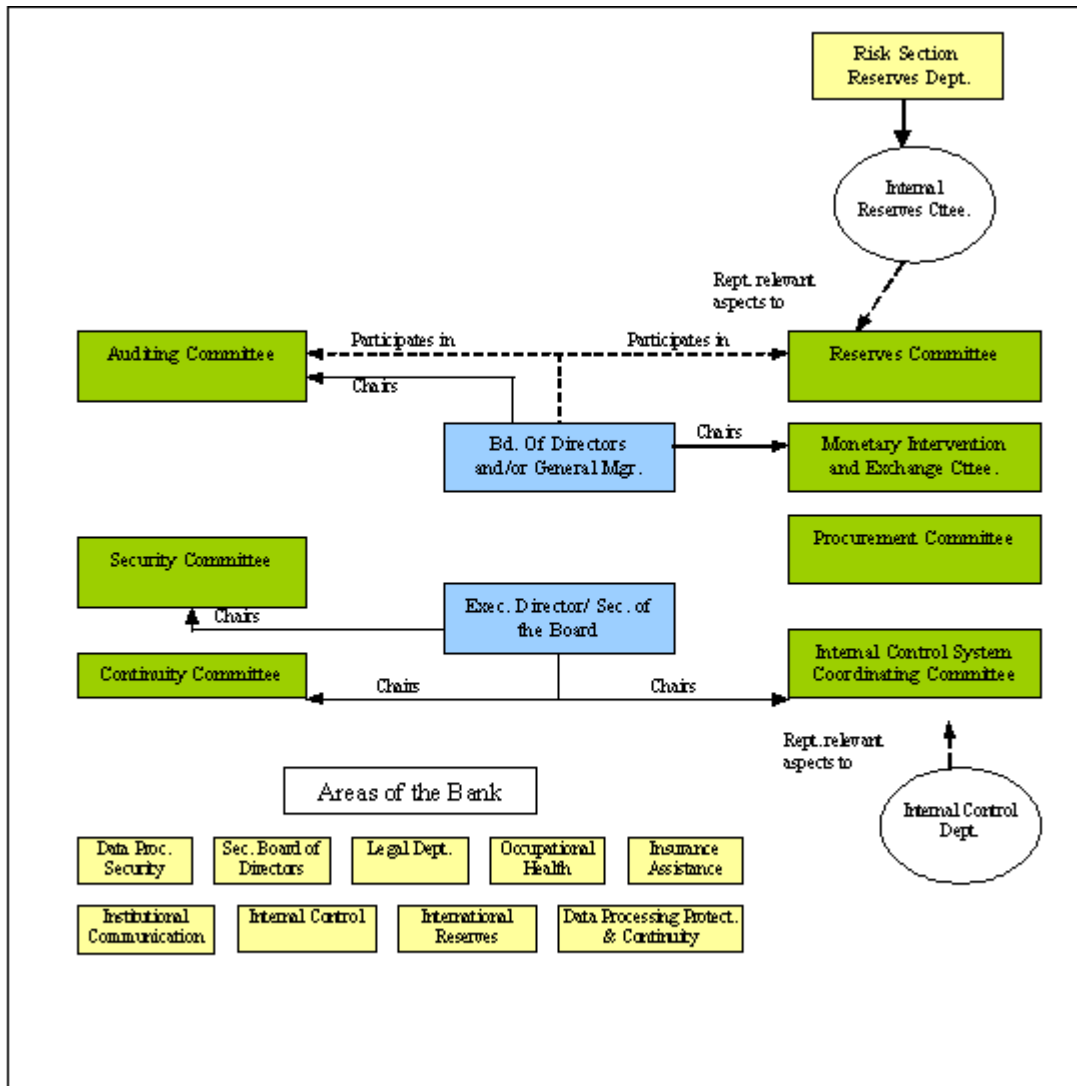
With the help of the Insurance Assistance Office, executive management designs, contracts and manages an insurance program with policies that cover physical assets and any eventual liability that might be incumbent on the Bank in exercise of its activities. This includes policies to protect the balance due on conventional and special loans in the event of the death of the beneficiary.

To ensure adequate coverage, the Insurance Assistance Office regularly conducts studies, with the help of insurance brokers, to determine risk tendencies and developments. The aim, in this respect, is to update the insurance program to line with real needs, to the extent the insurance market will permit.

Through the Internal Control Department, executive management regularly reviews and evaluates the status and progress of the internal control system, as well as compliance with the commitments

produced in the general auditing reports and in the ICSCC sessions. This review and evaluation is done with the areas and the branches.

Risk Committees



The graph shows how the committees relate to one another as part of the risk-management network at the Central Bank. In this respect, they define general policy, monitor its compliance, and adopt decisions based on the analyses and information they receive. The areas within the Bank are in charge of implementing these policies in light of the analyses that are developed.

2. Does strategic planning at the Bank contemplate an aspect associated with risk management? Will this aspect be addressed in the future?

The Planning and Budget Department (PBD) coordinates the strategic planning process, which includes an analysis of scenarios wherein potential risks and their impact on financial and

human resources are identified, as is their possible impact on the Bank's image. Strategies to mitigate these risks are defined as well.

Although risk identification and management is not explicitly reflected in the processes defined by the PBD, this activity is pursued in accordance with the best administrative practices.

3. Who establishes the criteria for risk acceptance and directs their application?

As indicated in the guidelines set by the Board of the Directors and the Management Board, each committee is responsible for drafting or establishing general guidelines and criteria on risk management. These, in turn, are translated into operational developments in each area that is responsible for a particular theme/process within the Bank. Each area directs the application of these guidelines and criteria. The committees themselves monitor this process during a subsequent review of established agreements and guidelines.

4. How are external institutions informed of the risk-management policy adopted by the Central Bank? What external institutions are involved? (E.g. The IMF recommended revealing the policy notes in accordance with NIC international guidelines.)

In written documents and/or articles published regularly by the Central Bank, or via its web site, the general public is informed about aspects involving the risk-management policies and practices applied within the institution. In addition, written reports with details on risk management are generated pursuant to the rules and requirements for institutions with delegated authority. The following are some of the institutions/agencies that receive reports from the Central Bank.

- A report by the Board of Directors is submitted to the Colombian Congress twice a year, as stipulated in Law 31/1992.
- The Annual Executive Report on Developments in the Internal Control System is submitted every year to the Government Advisory Board on Internal Control, which is coordinated by the Administrative Department for Public Service (DAFP)
- Quarterly reports on compliance goals are submitted to the International Monetary Fund (IMF).
- The Annual Report on the Internal Accounting Control System is submitted to the General Accounting Office.
- Questionnaires and reports resulting from the external audit conducted by Deloitte and Touche are answered.
- The General Auditing Office is informed, through replies to the reports that are produced and at the committee meetings it attends.

5. Is there a structure at the strategic level and another at the operational level to support risk management?

As noted earlier, the committees constitute the strategic level that supports risk management within the Central Bank. At the operational level, each area is responsible for managing the risks associated with the nature of its activities. The departments of International Reserves, Operations and Market Development, External Borrowing Facilities and Holdings, Physician and Health, Occupational Health, Trust and Securities, the Data Processing Security Unit and Data Processing Protection and Continuity Unit are some of the areas that play a prominent role in managing the different types of risks addressed at the Bank.

The Internal Control Department was created pursuant to the functions stipulated in Law 87/93. Among other activities, these include an assessment of operational risks and control over elements that are critical to the Bank². The more relevant aspects of these assessments are presented to the ICSCC. The Department also regularly monitors the commitments the areas have with this committee and with other control agencies.

6. If both levels exist, how to they operate, who is in charge, and are all the risks covered?

In general, the answers to the earlier questions touch on how risk management operates at the strategic level and its scope in relation to the risks that are covered. At the operational level, as mentioned in the reply to the previous question, besides the activities carried out by the areas with respect to risk management, the ICD conducts its own independent activities to identify critical elements and to assign them a priority. This includes analyzing, identifying, evaluating, addressing and monitoring the risks associated with those elements. These activities are defined in the Department's annual planning, pursuant to the appraisal criteria³.

On the other hand, the ICD lead an initiative in 2002 to identify the critical processes at the Bank. The information in the Processes and Procedural Manuals for each area was the primary input for this activity, and ICD professionals coordinated process review sessions with directors, deputy directors, section chiefs and the other responsible parties. The Executive Manager and the deputy directors reviewed and analyzed the findings of this activity, the end result of which was presented to and discussed by the ICSCC in December 2002, during Session No. 80. This exercise provided a preliminary map of the Bank's risks. The map was published later on the Intranet and is now available for consultation and use by the areas for activities such as risk management, planning, resource allocation, establishment of priorities, etc.

7. Who decides what risks the Bank manages at the strategic level? What are these risks? How is an organizational culture of risk management being encouraged within the Bank, and who is in charge of this function?

With respect to strategic risks, see the reply to question no. 2. On the other hand, the Bank is reinforcing its organizational culture on a variety of work fronts. The following are some important examples.

- The Program to Reinforce Values
- The Performance Management System, directed by the Human Resource Department, is intended essentially to empower human capital by developing the skills the organization needs.
- The Security Policy Promotion Campaign is being implemented under the direction of the Data Processing Security Unit. The aim is to encourage and reinforce safe data processing at the Bank.
- The Campaign to Make the Most of Resources (MMR) is being directed by the PBD to inform the Bank of progress on compliance with the strategic guidelines defined in this respect by the different areas within the institution.

² Critical element: A unit of analysis in the risk assessment process conducted by the ICD, be it a process, a project, an organizational unit, a geographic location or an opportunity.

³ Appraisal criteria: Aspects of interest to fulfillment of the Bank's functions. These criteria are presented and approved by the Internal Control System Coordinating Committee (ICSCC), in order to identify and catalogue the critical processes at the Bank.

- There are a number of ICD activities to reinforce a culture of self-discipline and control. For example, the Department's annual activity plan includes workshops for the different areas and branches of the Bank on topics related to building concepts of risk, controls and other aspects that contribute to risk management. In addition, as part of its assessment activities, the ICD has conducted initial risk-management exercises in which the areas are actively involved. The frame of reference for these exercises is a guide developed and maintained within the Bank. The structure of this guide is based on the Australian standard (ASNZ-4360) and the COSO Model

8. How is risk management monitored at the strategic level? (Regular reports received on results concerning assumed risks; who sends them and how often)

An account of risk management is given through presentations and reports submitted to the committees that comprise the strategic level. By regulation, each of them has an established plan or procedure for operation and meets according to a certain schedule.

ASSET AND LIABILITY MANAGEMENT

1. Does the Bank consider management of an amount of risk capital and financial management of assets and liabilities viable?

The concept of risk capital in an institution with twice as many assets as liabilities and with 52% of its liabilities represented by "currency" reflects a total absence of financial leveraging and has no direct application. In the case of international reserves, asset management is based on a risk profile or aversion to loss with respect to portfolio investments. The Committee on International Reserves has a rule that the reference index, which is used to measure the performance of portfolio managers, may show no negative returns in any year with a probability of no more than 5%. This is used to determine the interest rate risk that can be assumed. A risk budget that is equivalent to 50 basis points (bp) replica error a year, or risk relative to the reference index, is used for active portfolio management.

As to risk management for institutional loans, the External Borrowing Facilities and Portfolio Department (EBFPD) relies on the guidelines specified in Circular 100/1995 issued by the Banking Superintendent. Moreover, in response to regulations established by the Banking Superintendent in terms of having a credit risk management system (CRMS), the EBFPD developed a method during the past year that takes into account the effect of repercussions from default loans to obtain a recovery rate. It also devised a method for estimating anticipated losses, based on transition matrices, and built a model to support CRMS operation at the Bank.

2. Has a policy been defined for asset and liability management within the Bank? Who conducts this activity and how often?

Based on the theoretical definition, which is aimed at applying the concepts and measurements (duration/convexity) involved in strategies to "immunize" a bank's balance sheet to changes in interest rates, there has to be a perfect match between the duration of asset and liability positions. If not, the institution's assets will be exposed to fluctuations associated with changes in interest rates.

In this respect, the Central Bank has no liabilities with depositors or third parties that require it to pay interest. Accordingly, a policy for asset and liability management of the kind required within financial institutions is not considered practicable, since a measure of

this sort is intended to determine the extent to which assets could back liabilities towards third parties at a given moment.

3. Is there an assessment of the potential losses the institution could incur in crisis situations?

As part of a process to review, investigate and adopt best practices, the Central Bank has made a considerable effort to analyze crisis scenarios? This aspect is reviewed as part of the risk assessment and analysis activities developed by the ICD in conjunction with the areas and branches. These assessments include a qualitative view of potential risk that always considers the worst case scenario. This helps the participants to think in a creative and analytical way, to envision themselves in possible risk scenarios, and to identify possible causes of risk, as well as their impact (slight, moderate or serious) and the frequency with which they could occur.

To supplement the foregoing, the Central Bank established the Data Processing Protection and Continuity Unit (DPCU), which has specific tasks in terms of advice and coordination for the continuity of vital processes. The DPCU has defined a general continuity program to minimize the impact a disaster situation or incident could have on the Central Bank.

The advice the DPCU provides is in line with the Disaster Recovery Institute method. One of the phases of that method includes risk management for prevention, mitigation, response, resumption and recovery in the event of crisis situations. In this respect, the DPCU develops contingency plans, in conjunction with the areas and branches of the Bank, to be able to respond to crisis situations. An analysis of scenarios involving possible shortcomings or failure in infrastructure, processes or systems, among other elements, goes into the design of these plans.

The general program for continuity also involves aspects that deal with protecting and saving human lives, protecting property and reinforcing the communication and information that are essential in situations of this type. It also helps to instruct the areas in developing strategies/actions to cope with any type of disaster or crisis situation, even without explicit plans for recovery.

As to the portfolio of international reserves, tests are performed regularly under stress scenarios to determine the potential losses in crisis situations that can occur on financial markets. However, given the profile of reserve investments, where assets are considered a "safe-haven" during times of systemic crisis in the world, these securities tend to appreciate in value. This is an important point to remember.