TECHNICAL ASSISTANCE REPORT

COLOMBIA

Open-Ended Fund Liquidity

May 2025

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Glossary

BanRep	Banco de la República de Colombia (the central bank of Colombia)
CCSSF	Financial System Coordination and Monitoring Committee
CIS	Collective Investment Scheme
Colombian Authorities	BanRep, the SFC and the URF collectively
COP	Colombian Peso
EU	European Union
FI-OEF	Fixed income open-ended fund without permanence
FSB	Financial Stability Board
HQLA	High Quality Liquid Assets
IOSCO	International Organization of Securities Commissions
LMT	Liquidity Management Tool
LRI	Liquidity Risk Indicator
MMF	Money Market Fund
NAV	Net asset value
OEF	Open-ended fund without permanence
RNVE	Registro Nacional de Valores y Emisores (National Registry of Securities and Issuers)
SFC	Superintendencia Financiera de Colombia (Financial Superintendence of Colombia)
URF	Unidad de Proyección Normativa y Estudios de Regulación Financiera (Unit of Regulatory Projection and Financial Regulation Studies)
WAL	Weighted Average Life
WAM	Weighted Average Maturity

Preface

At the request of the Financial Superintendency of Colombia (SFC), the Financial Regulation Unit of the Ministry of Finance and Public Credit (URF), and Banco de la República (BanRep), a Monetary and Capital Markets (MCM) Department mission visited Bogotá, Colombia from March 10 to March 14, 2025 to assist the authorities in identifying potential improvements to the framework for liquidity risk management of open-ended investment funds (OEFs).

The mission team was composed of Nick Green (external expert) and Richard Stobo (MCM).

The mission met with Governor Villar and other senior BanRep officials, representatives of the SFC and URF, and a range of market participants from the private sector. The mission wishes to thank the authorities for their cooperation, productive discussions, and their hospitality.

Executive Summary

The Financial Superintendency of Colombia, Ministry of Finance and Public Credit, Financial Regulation Unit, and Banco de la República (BanRep) (collectively "the Colombian Authorities") requested technical assistance (TA) to assess the current regulatory framework for liquidity risk management of open-ended investment funds (OEFs). The MCM mission team gathered detailed information about the regulatory and supervisory framework via a questionnaire and data request to the authorities, which laid the groundwork for the in-person mission that took place in Bogotá, Colombia from March 10 to March 14, 2025. The mission team held extensive discussions with the authorities as well as a range of market participants from the private sector.

Liquidity risk management of OEFs has been a key topic of discussion among international policymakers in recent years, notably the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO). Amendments to international standards have recognized the significant growth of investment funds' share of the financial sector in many jurisdictions, as well as their increasing interconnectedness with credit institutions. Common themes underlying these changes are the importance of alignment between the liquidity of funds' underlying assets and their redemption policies, as well as the valuable role that can be played by liquidity management tools (LMTs) such as gates and deferred redemptions.

The authorities should ensure that the SFC has the requisite powers address potential OEF illiquidity risks more effectively, and that it is able to operationalize those powers. First, a power should be established in applicable laws to enable the SFC to unilaterally suspend dealings of units in an OEF. This recommendation would address a gap in the powers of the SFC, whereby it obtains extensive data on developments in OEF liquidity but currently has to rely on OEF managers invoking contingency plans to ensure that liquidity risk is adequately mitigated. Similarly, the SFC should be given the power to direct an OEF to convert from an OEF to a CIS with a permanence agreement, effectively requiring it to significantly reduce its redemption frequency, where doing so would be in the interests of investors.

Changes to the regulatory framework for MMFs are warranted to reduce their risk profile, in line with international standards. Adjustments to the weighted average maturity (WAM) and weighted average life (WAL) thresholds would allow for those investors who are utilizing MMFs as a stability and capital preservation vehicle to be directed to the lowest risk options. While generally recommending MMFs adopt a lower risk profile, the mission also recommends that the Colombian authorities consider whether to permit MMFs to invest more than the current 5 percent maximum unhedged exposure to non-COP denominated assets. This should be seen against the background of Colombian corporate credit markets being relatively shallow and illiquid; as such, allowing OEF Managers to obtain additional exposure to liquid money market instruments denominated in foreign currencies may increase liquid assets in MMFs.

Although fixed income OEFs are covered by strong rules on minimum levels of liquidity, the Colombian authorities should explore additional measures to ensure these OEFs maintain sufficiently liquid assets to meet redemptions. This should include complementing the LRI as a minimum level of liquidity with an explicit maximum percentage of NAV capable of being invested in illiquid assets. In addition, rules requiring that a minimum percentage of the portfolio be made up of diversified portfolio assets (by issuer type) would address the current situation whereby exposures tend to be concentrated in a small number of issuers of corporate debt. The authorities should consider requiring a minimum level of OEF holdings are both liquid and listed on an applicable exchange, which could incentivize certain portfolios to reorientate some exposure away from corporate credit to listed sovereign debt. These recommendations are confined to fixed income OEFs. This is because the mission team found that the MMF sector merited separate measures, primarily focused at reducing WAM and the implementation of WAL limits.

The regulatory framework should be amended to ensure clarity regarding the LMTs available to OEF Managers. LMTs that would be of most benefit to the Colombian market are share classes with notice periods, gates, and a minimum balance at risk requirement. The introduction of these LMTs would be an additional component of an OEF Manager's toolkit to help manage liquidity, but they should not be seen as a substitute for measures ensuring that the liquidity of the portfolio holdings matches the liabilities of the OEF. As detailed later in this paper, we have not suggested that use of LMTs by OEF Managers be obligatory.

Finally, the mission recommends establishing an inter-agency working group to address the recommendations contained in this report. Such an approach will allow the different perspectives and roles of each agency to be reflected: financial stability monitoring (BanRep), supervision and investor protection (SFC), and legal drafting and policy development (URF). In addition, a cooperative approach across the agencies will allow a more comprehensive assessment of the trade-offs involved in some of the options, such as whether to prioritize bank funding or investor protection in the context of MMF reforms. The working group could also serve as the primary point of contact for industry interactions regarding potential changes to the regulatory framework, including discussions on timing and implementation.

Recommendations

Table 1. Recommendations

Recommendations and Authority Responsible for Implementation	Priority	Timeframe 1/
Recommendation 1: Supervision of OEF liquidity (SFC and URF)		
Changes should be made to applicable rules and laws to better enable effective supervision of OEF liquidity risk.	3	Medium Term
Recommendation 2: MMF Risk Profile (SFC and URF)		
Changes should be made to applicable rules and laws to reduce the risks capable of being taken by MMFs and reduce vulnerabilities in the MMF sector.	2	Medium Term
Recommendation 3: Liquidity of Fixed Income OEFs (SFC and URF)		
Colombian authorities should explore additional measures to ensure fixed income OEFs maintain sufficiently liquid assets to meet redemptions.	4	Medium Term
Recommendation 4: Liquidity Management Tools (SFC and URF)		
Changes should be made to applicable rules, laws and guidance to ensure OEF Managers have the requisite clarity regarding the potential to apply Liquidity Management Tools.	5	Medium Term
Recommendation 5: OEF liquidity working group and development of risk appetite (cross-agency)		
The Colombian Authorities should establish a cross-agency working group to assess the recommendations in this report and establish a risk appetite concerning the systemic risks posed by OEFs.	1	Near Term

1/ Near term: < 12 months; Medium term: 12 to 24 months.

I. Introduction

A. Outline and scope of mission

1. The mission was conducted in several phases:

I. an initial questionnaire prepared by the mission team and completed by the Colombian Authorities, with additional supporting material provided in January 2025;
II. an onsite mission to Colombia in March 2025, including meetings with senior officials and representatives of the Colombian Authorities and market participants;
III. drafting of this report; and
IV. due diligence and approval by the IMF for publication, which occurred between March and July, 2025.

2. The authorities requested technical assistance to assess the current regulatory framework for liquidity risk management of open-ended investment funds (OEFs) and identify potential improvements. In carrying out this analysis and developing the corresponding recommendations, the mission team took into account the specificities of Colombian capital markets in general and its OEF sector in particular. The recommendations focused on strengthening the resilience of the OEF liquidity risk management framework rather than on the development of the OEF sector or of capital markets as a whole. It is recognized that some of the recommendations would be easier to implement if there were broader and deeper markets for certain asset classes in Colombia, but measures specifically targeted at the development of such markets are outside the scope of this TA.

B. Context

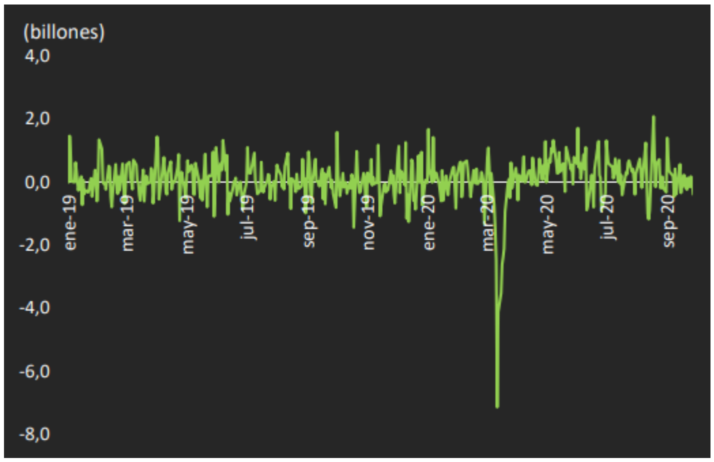
3. During early 2020, uncertainty about the impact of the Covid-19 pandemic on the global economy caused widespread stress in financial markets. Markets were affected across the board as investors sought to derisk exposures and reprice assets. In the case of OEFs, this 'flight to quality' took the form of significant redemptions, both in OEFs generally and MMFs particularly. In Colombia, the average OEF experienced redemptions totaling a third of fund NAV. In some OEFs, this figure reached 50 percent of fund NAV. Another factor that distinguished the experience of Colombian MMFs during March 2020 was that no sub-sector of OEF experienced net subscriptions. In many other jurisdictions, the flight to quality took the form of moving investments from OEFs exposed to relatively more risky assets to those OEFs exposed to lower risk. For example, during this period, the FSB reports that so called 'government' MMFs (those with significant exposure to sovereign credit instruments) attracted inflows amounting to between 20 and 60 percent of their NAV compared to January 2020 in countries such as Ireland, Luxembourg and the US. In comparison, outflows in so-called 'prime' MMFs (those with significant exposure to commercial credit instruments) amounted in to around 20-30 percent of NAV compared to NAV in January 2020 in those same countries[1]. This phenomenon was not observed in Colombia because, as this report outlines, the Colombian market has evolved into one which can be

[1] https://www.fsb.org/uploads/P111021-2.pdf see figure 4, page 18

characterized as exclusively a 'prime' MMF Market. The lack of a 'risk off' sub-sector of OEFs and MMFs in the Colombian market was a key focus of this mission, and the subject of Recommendation 2.

4. The scale of redemptions in Colombian OEFs was extraordinary. Within the month of March 2020, investors withdrew COP 24.6 trillion, decreasing sector AUM by around 32 percent.[2] The dramatic scale of redemptions is illustrated by the below chart, published by BanRep, showing the decline in billions of USD:[3]

Figure 1. Effect of the Covid-19 Pandemic on net flows in Colombian OEFs



5. Unlike many global peers, no OEF in Colombia failed to honor redemption requests during this period ("suspension"). Suspension denotes that the OEF cannot honor redemptions requests, usually because assets cannot be liquidated quickly enough to fulfil redemptions, while also ensuring remaining investors are not unduly disadvantaged by the changing asset composition of the portfolio. The resilience of Colombian OEFs contrasted with other more mature jurisdictions, such as the EU, where OEFs did suspend. Between mid-February and end-March 2020, at least 215 EU OEFs with assets totaling €73.4 billion suspended for varying time periods.[4] Indeed, the Colombian Authorities report that no Colombian OEF suspended during the period reviewed by the mission team (March 2020-March 2025). Nevertheless, levels of liquid assets (particularly cash) in Colombian OEFs fell significantly during the period.[5]

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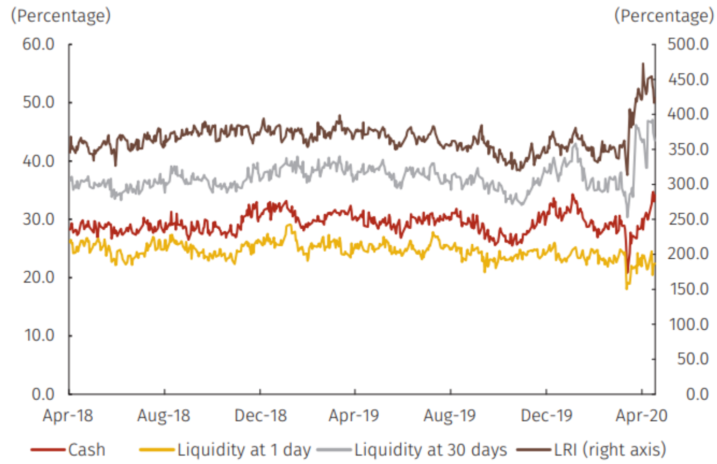
[2] https://doi.org/fzzb BanRep Financial Stability Report, H2 2020, page 75

[3] https://www.banrep.gov.co/sites/default/files/publicaciones/archivos/presentacion-reporte-estabilidad-financiera-segundo-semestre-2020.pdf

[4] https://www.ecb.europa.eu/press/financial-stability-publications/macroprudential-bulletin/html/ecb.mpbu202104_3~a7ddbf0d16.en.html

[5] https://doi.org/fx2x

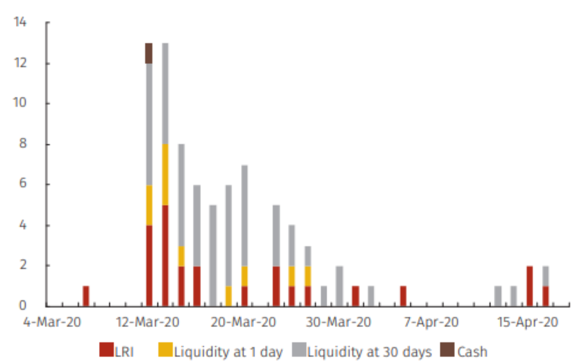
Figure 2. Effect of the Covid-19 Pandemic on OEFs' Liquidity Indicators



Source: Office of the Financial Superintendent of Colombia, calculations: *Banco de la República.*

6. However, similar to many other jurisdictions, on March 12, 2020, BanRep intervened meaningfully to alleviate the threat of a liquidity crunch in Colombian OEFs. For example, BanRep intervened to extend access to repo facilities, extending such measures to private debt securities (in which Colombian OEFs were and are heavily exposed).[6] The below graph, produced by BanRep, shows the number of OEFs (labelled as "CIFs", or Collective Investment Funds) that failed to comply with regulatory minimums of various liquidity requirements, including 1-day and 30-day liquidity. The graph also shows the impact of BanRep's interventions, as the declining number of defaults shows the easing of liquidity stress as BanRep's measures took effect:

Figure 3. Liquidity Indicator Defaults by CIFs (OEFs)[7]



Note: the number of CIFs that fail to comply with each indicator is on the graph. It is possible for a fund to fail to comply with several indicators, so the height of each bar does not necessarily represent the total number of CIFs that fail to comply per day.
Source: Office of the Financial Superintendent of Colombia, calculations: *Banco de la República.*

7. Colombian OEFs are growing in importance as a source of capital for the Colombian banking sector. For example, the mission team learnt that nearly 90 percent of OEF investments were

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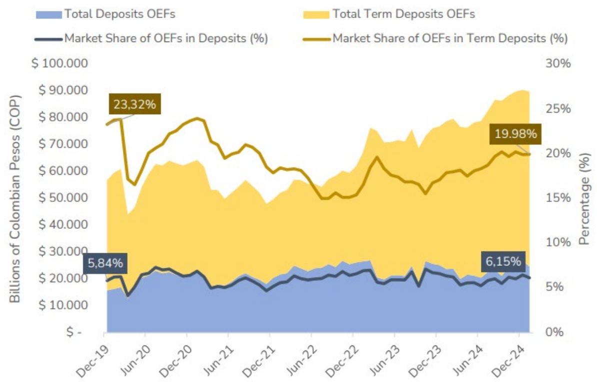
[6] https://doi.org/fx2x BanRep Financial Stability Report, H1 2020, page 48.

[7] https://doi.org/fx2x BanRep Financial Stability Report, H1 2020, page 48.

composed of certificates of deposits and savings accounts, representing around 6 percent of banks' total demand deposits.[8] Given this, it is of significant importance that the Colombian OEF market be resilient to liquidity shocks and capable of withstanding periods of volatility.

Figure 4. Participation of OEFs in banking deposits



Regulatory Authorities governing OEF liquidity in Colombia

8. The President of Colombia is empowered by law and the Constitution to issue decrees, resolutions, and orders to enforce laws and to intervene comprehensively in the securities market, particularly concerning regulations on investment funds.[9] Article 211 of the Constitution permits the delegation of specific functions to ministers and superintendents. Accordingly, the President authorized the Ministry of Finance to regulate matters related to financial, stock market, and insurance activities and other activities concerning the management, utilization, and investment of resources collected from the public. In consequence, the "Unidad de Proyección Normativa y Estudios de Regulación Financiera" (Unit of Regulatory Projection and Financial Regulation Studies – URF) was established.[10]

9. The purpose of the URF is to prepare regulations for the exercise of regulatory power in foreign exchange, monetary and credit matters, as well as on the regulatory and intervention powers in financial, stock market, insurance. According to these, the URF also prepares regulations governing the management of investment funds, which the National Government issues through the Ministry of Finance.

10. The President has delegated to the "Superintendencia Financiera de Colombia" (Financial Superintendence of Colombia – SFC) the responsibilities of inspection, surveillance, and control over entities engaged in securities market activities, including those on the management of investment funds.[11] To fulfil its objectives of inspection, surveillance, and control, Article 326, numeral 3,

[8] Source: BanRep and https://repositorio.banrep.gov.co/server/api/core/bitstreams/170d9a1f-b6d9-4d1d-b799-f1f1c01b3968/content page 6

[9] Law 964 of 2005 and Articles 189, numerals 11 and 25 of the Constitution.

[10] Decree 4172 of 2011, later amended by Decree 1658 of 2016.

[11] In accordance with Articles 189 and 211 of the Constitution.

literal (a) of the "Estatuto Orgánico del Sistema Financiero" (Organic Statute of the Financial System) specifies that one of the SFC's functions is to instruct supervised entities on compliance with the provisions regulating their activities, establish technical and legal criteria to facilitate adherence to such regulations, outline procedures for their full implementation, and guide these institutions on managing the inherent risks in their operations. In this context, the SFC, as the administrative authority specializing in the supervision of the securities market and particularly in the supervision of investment funds, is responsible for issuing general guidelines on various aspects of this activity: defining how supervised entities should comply with applicable regulations, establishing technical criteria to facilitate adherence, outlining procedures for proper implementation, and determining how these institutions should manage the inherent risks associated with their operations.

11. BanRep, meanwhile, monitors the entities that comprise the financial system (including OEFs) under its mandate to preserve the national currency's purchasing power, support sustained economic growth and contribute to financial stability. Additionally, it issues regulations concerning foreign exchange matters, which apply to funds in case they engage in currency transactions. In exercising its mandate to contribute to the stability of the financial system, BanRep may adopt measures if it identifies a need to regulate the economy's liquidity. These measures include temporary/permanent liquidity provision/contraction to the financial system with public and private debt securities.

12. BanRep and the SFC make up the Financial System Coordination and Monitoring Committee (CCSSF). The CCSSF monitors systemic risks and coordinates macroprudential policies and other regulatory measures to mitigate financial risks.[12]

OEFs in Colombia

13. Collective Investment Schemes in Colombia can take five main forms as defined by regulation: Closed-Ended Funds, Open-Ended Funds, Exchange-Traded Funds (ETFs), Money Market Funds (MMFs), and Real Estate Funds. OEFs can be further broken down into those 'with permanence agreements' and those 'without permanence agreements'. The scope of this mission covers only those Open-Ended Funds without permanence agreements, OEFs. Permanence agreements in this context effectively mean less frequent redemptions (such as monthly). However, OEFs must accept dealing in units daily, although applicable laws allow for some flexibility regarding settlement time, dependent on the portfolio assets liquidated to meet the redemption request. For ease of understanding, only those CIS without permanence agreements are referred to as OEFs in this report. No concern exists regarding the liquidity of Closed-Ended Funds, Exchanged-Traded Funds, or those CIS with permanence agreements. In short, this is due to an appropriate level of consistency between these funds' dealing frequency and the liquidity of their underlying assets.

[12] https://www.elibrary.imf.org/view/journals/002/2022/157/article-A001-en.xml

14. As at 30 December 2024, assets under management in Colombian OEFs amounted to COP 109.6 trillion, circa USD 27.8 billion as per exchange rates on the same date.[13] There are 86 OEFs in total. These are split between the three categories of OEF.[14]

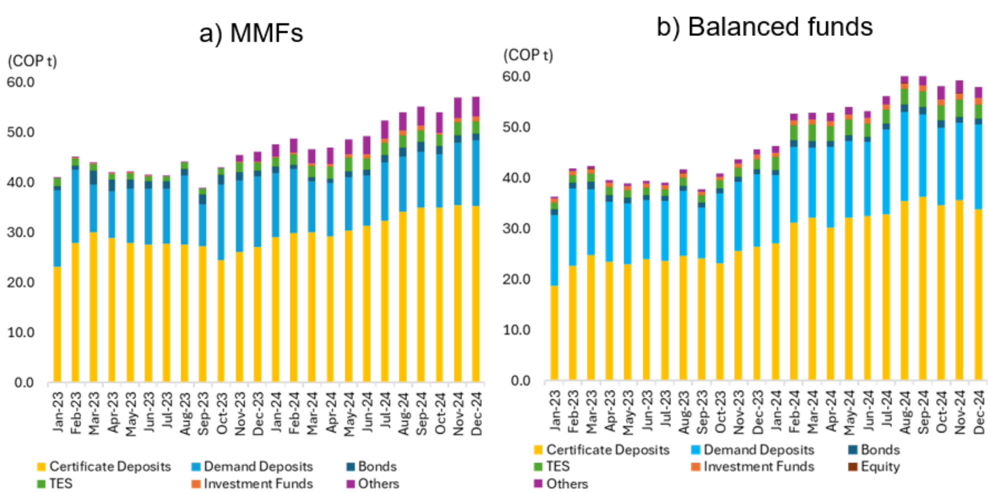
Table 2. OEFs in Colombia

OEF Type	Number of OEFs	AUM as at 30 December 2024
Money Market Fund ("MMF")	16	~49 trillion COP
Variable-income (equity)	9	~0.6 trillion COP
Fixed Income OEF "FI-OEF")	61	~60 trillion COP

15. In comparison to some jurisdictions, the Colombian OEF market stands out as having a low number of equity funds in comparison to other OEF types. This appears to be a function of low investor demand for Colombian equities, with the stock exchange dominated by a small number of inter-related issuers.[15] The low liquidity of the domestic equities markets may also be a factor.

16. Another striking feature of the Colombia OEF market is the similarity in portfolio holdings held by FI-OEFs and MMFs. Data provided by the Colombia Authorities shows that FI-OEFs and MMFs share a strikingly similar asset mix in their portfolios (see Figure 6, below).[16]

Figure 5. Portfolio composition of Colombian MMFs and FI-OEFs, 2023-2024



17. The data provided by the Colombian Authorities shows that MMFs and FI-OEFs invest over 85 percent of their holdings in certificates of deposits and demand deposits. The similarly of the

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[13] Source: the Colombian Authorities

[14] Source: the Colombian Authorities

[15] https://documents1.worldbank.org/curated/en/099010004112241518/pdf/P17314204e921c0430aacb0c320cb7f9e13.pdf, paragraph 67

[16] Source: the Colombian Authorities

holdings cannot be explained by the regulatory framework. The below table specifies the regulatory limits MMFs and FI-OEFs must adhere to insofar as liquidity of assets is concerned. However, the limits do not provide a clue as to why portfolio assets are so similar across OEF types:

Table 3. Regulatory OEF Liquidity Requirements

MMFs	FI-OEFs
At least 5 percent in cash	No cash requirement
At least 10 percent in liquid resources (1-day liquidity)	5 percent in liquid resources
At least 25 percent in 30-day liquidity.	No 30-day liquidity requirement
At least 10 percent of NAV in HQLA	At least 10 percent of NAV in HQLA
LRI greater than 100 percent (LRI = the ratio of assets that can be liquidated compared to maximum probable redemptions)	LRI greater than 100 percent

18. The similarity in asset mix found in MMF and FI-OEF portfolios can likely be explained to a large extent by Colombian investors' preferences. The risk-return profile of certificates of deposit and term deposits in Colombia is generally good, when compared to the risk-return profile of other asset classes such as longer-dated corporate debt and sovereign debt. Another potential cause is the limited availability of other types of liquid instruments in domestic capital markets. Irrespective of the drivers for the similar asset mix between the two types of OEF, it is highly relevant to the findings of the mission, and explored in further detail later in the paper.

19. Recent evidence suggests a potential shift in the composition of OEFs' portfolios towards non-traditional assets. According to BanRep analysis, the share of non-traditional investment in the total assets of the ten largest investment funds increased from 1 percent in 2023 to 9 percent in 2024.[17] This included increased shares of treasury securities issued by foreign governments, CDs issued by foreign banks, and equity securities issued by entities not supervised by the SFC. BanRep notes in the same analysis, however, that: i) this is a recent trend (only 12 months of data); (ii) liquidity levels of funds are actually higher than in 2023; and (iii) OEFs were substituting in T-Bills for cash during that same period. It is difficult to determine whether these recent shifts will develop into a long-term trend, or what the implications of such a change would be.

Colombian capital markets

20. Market practice and convention has led OEFs to primarily invest in Colombia-domiciled assets, being equity, sovereign and corporate credit, deposits, and other OEFs. Despite a large, liquid local currency government bond markets, capital markets for corporate debt in Colombia are shallow.[18] This context is crucial to the findings of this review and the recommendations herein, as OEFs'

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[17] BanRep Financial Stability Report, H2 2024

[18] https://documents1.worldbank.org/curated/en/099010004112241518/pdf/P17314204e921c0430aacb0c320cb7f9e13.pdf, paragraph 63

investable universes are limited by this lack of depth in local capital markets. It also means regulators' options in setting rules pertinent to OEF liquidity are limited. For example, requiring all OEF assets to meet minimum thresholds of liquidity may not be realistic given shallow capital markets. Meanwhile, OEFs are market participants that can help support market liquidity, therefore driving OEFs away from sections of Colombian capital markets (such as corporate credit) by requiring them to invest in more liquid assets could have a broader negative policy impact. Policymakers have sought to develop the local capital markets via various reforms.[19] For example, Decree 1239 of 2024 seeks to enhance the liquidity of domestic capital markets by facilitating intermediation and improving the conditions for issuing securities, although discussions with the authorities and stakeholders during the mission suggested it may be too early to assess the long-term impact of this measure.

21. The mission team recommends taking a gradual and proportionate approach to regulatory change in the area of OEF liquidity. This is partly due to there being generally a good framework aimed at ensuring minimum levels of liquidity in OEFs which has resulted in no OEF suspending during the time period reviewed. However, it also because the aforementioned shallowness in Colombian capital markets warrants a proportionate approach when considering requirements concerning assets in which Colombian OEFs may invest. For example, the mission did not see a strong case for allowing OEFs to invest only in assets that are listed on an exchange, as is the case in some jurisdictions. This is because such an approach would unreasonably restrict the OEF sector which, as established above, has experienced several periods of redemption volatility without experiencing any suspensions. Shrinking the investable universe of Colombian OEFs could potentially reduce OEFs' demand for Colombian assets, leading to a vicious circle of declining liquidity in Colombian capital markets. Our recommendations should, therefore, be considered in the broader context of policies seeking to enhance liquidity in Colombian capital markets.

II. Risk Mitigation and Recommendations

A. Supervision of OEF Liquidity

22. The review found several areas of best practice in the regulation and supervision of OEFs leading to an overall conclusion that it was robust in many of its features, with some areas for incremental improvements.

23. OEF liquidity in Colombia is governed by a regulatory framework that sets strong parameters for minimum liquidity. In MMFs, this is established by minimum requirements for 1-day and 30-day liquidity, minimum cash levels and a further requirement for 10 percent of net asset value (NAV) to be in high quality liquid assets (HQLA). The minimum liquidity standards for Fixed Income OEFs are also strong, entailing requirements for 5 percent of NAV to be held in liquid resources, and 10 percent of NAV to be in HQLA.

24. An additional important feature of minimum requirements in OEFs is the Liquidity Risk Indicator (LRI). The LRI is a tool that measures an OEF's ability to meet its liquidity requirements. The OEF must hold HQLA equivalent to 100 percent of either its highest potential redemption, or 10 percent of NAV (whichever figure is higher). Inherent in the LRI's calculation is an estimation by the OEF Manager of the OEF's liquidity requirements, which is an estimation of the maximum potential redemption in one day (based on historical redemptions and with 95 percent confidence). As a prudent measure, the lowest possible one-day net redemption to be taken account of is 10 percent of NAV, which is a significant figure. The LRI is therefore a prudent measure, and reported weekly (via 'Formato 519') to the SFC, which monitors OEFs that come close to breaching the minimum liquidity levels set by the LRI.

25. The SFC's measures to gather data relevant to OEF liquidity, including the minimum levels set out above, are strong. Data relevant to OEF liquidity, particularly regarding asset liquidity and adherence to minimum cash and HQLA levels, is reported weekly.[20] Frequency of submission can be increased to daily where deemed appropriate by the SFC, such as during periods of heightened concern regarding liquidity issues. The SFC uses the data to establish a fund-by-fund picture of liquidity in the population of OEFs. It engages with OEF Managers where reporting shows that liquidity is deteriorating. Furthermore, Chapter 31 of Basic Accounting and Financial Circular contains the Comprehensive Risk Management System (SIAR in Spanish), which sets applicable rules regarding risk management in financial institutions. It requires that OEF Managers have processes in place to ensure strong risk management processes and procedures. The SFC engages with OEF managers to ensure that these processes are implemented to increase liquidity where appropriate.

26. The SFC also undertakes its own liquidity stress testing of OEFs, utilizing the asset liquidity data it gathers directly from OEF Managers to do so. The liquidity stress testing involves not just stress testing of liabilities (via redemptions) but also assets (via declining asset values). This approach is consistent with international best practice. The SFC uses its liquidity stress testing to identify

[20] The fund's custodian also has access to this data.

OEFs which are more at risk of experiencing liquidity issues, and liaises with OEF Managers to establish how liquidity risk is being mitigated.

27. However, there are recent developments in applicable laws which are less favorable to the SFC's mitigation of liquidity risk in OEFs. In 2024 applicable rules were amended to allow new OEFs to establish without going through an authorization process at the SFC. The measure allows for OEF Managers to establish new OEFs in a more efficient manner and, according to the Colombian authorities, there are several measures in place to help mitigate the risk associated with new OEFs not being formally authorized by supervisory teams. These measures include self-certification of compliance with applicable laws by OEF Managers, and a role for the custodian in monitoring an OEF's adherence to investment restrictions established in the prospectus. However, authorization can play an important role as a control to help ensure that, on an ex-ante basis, the design of an OEF (including its proposed assets and redemption terms) is appropriate.[21] In Colombia, this is particularly pertinent where, partially due to shallow capital markets, one of the key questions at design stage for a CIS is whether it should be established with or without permanence. The risk posed is mitigated by the relatively low number of new OEFs being established in Colombia, with the SFC reporting that only four were authorized in 2024. The recommendations in this section recognize that applicable laws were changed recently, and therefore suggest other means of mitigating the risk that OEFs may be established which do not have an appropriate alignment between assets and redemption terms.

Recommendations

28. The mission's first recommendation is that a power be established in applicable laws to enable the SFC to unilaterally suspend dealings of units in an OEF. This recommendation arises from a gap in the current powers of the SFC, whereby it obtains extensive data on developments in OEF liquidity but currently has to rely on OEF Managers invoking contingency plans to ensure that liquidity risk is adequately mitigated. There is a possibility that an OEF Manager will fail to invoke contingency plans or that such plans may fail. In such circumstances, it is also possible that an OEF Manager will be hesitant to suspend dealing of units in the OEF, possibly because doing so will have negative consequences for its reputation, and therefore its business. However, suspension of dealing in units can be an important tool for ensuring that remaining investors are not unduly exposed to the remaining, less liquid components of an OEF, or indeed an OEF which has breached investment restrictions in an effort to satisfy redemptions. Consequently, the mission recommends that the SFC be granted this power under applicable laws.

29. Several factors should be considered prior to the SFC actually exercising the power to suspend dealing in an OEF, as covered in detail by IOSCO.[22] One potential trigger for the suspension power is a repeated failure to meet the LRI requirements. This is because, as outlined above, the LRI is a strong control to ensure remaining investors are not unduly exposed to an illiquid OEF, or one whose assets no longer adhere to the strategy set out in the Prospectus. However, it would be for the SFC to determine the triggers that would lead to such an intervention.

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[21] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD770.pdf, Section 2.3, Role of Securities Regulators

[22] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD770.pdf, Section 2.3, Role of Securities Regulators

30. Applicable laws should be reviewed to ensure clarity that the SFC has the power to direct an OEF to convert to a CIS with a permanence agreement, effectively requiring it to significantly reduce its redemption frequency, where doing so would be in the interests of investors. One of the drivers for this recommendation is the recent decision of the Colombian authorities to enable OEFs to be established without explicit authorization by the SFC. As detailed above, this leads to a risk that OEFs will be established with a mismatch between the redemption terms and liquidity of OEF assets. From a liquidity perspective, it is always preferable to maintain a 'gateway' or control via an authorization requirement on OEFs. However, we recognize that, given the recent change of applicable laws, it would be undesirable to reinstate the authorization requirement in the near term, in view of maintaining the principle of legal certainty upon which a well-functioning market relies. In lieu of an authorization function challenging, and having the power to refuse to authorize funds, the onus rests on the SFC's fund supervisors to take action to address any funds that should reasonably have been established as funds with permanence, rather than OEFs. The SFC is currently well-placed to undertake this intervention given the frequency with which it receives reports on OEF liquidity levels (see paragraphs 25 and 26 above). The mission team notes that IOSCO's draft Recommendations envisage supervisory authorities taking a proactive approach in moving CISs into differing categories (including the equivalent of CISs with permanence) where appropriate.[23] This initiative could also be complemented with additional guidance for OEF Managers on the circumstances under which the SFC would expect a CIS to be established as an OEF, and when it would be better established as a CIS with a permanence agreement.

31. The final recommendation relates to the SFC's liquidity stress testing exercises, which the mission found to be very good. The SFC should specify the parameters under which OEF Managers must undertake their own liquidity stress tests, including reverse stress testing, in order to ensure a minimum standard is met across the market. It is suggested that the SFC's own approach to liquidity stress testing, including stress testing both the asset and liabilities side of an OEF's balance sheet, be the minimum standard by which OEFs adhere to applicable rules. However, this would be for the SFC to determine based on its own analysis and preferences.

B. MMFs' Risk Profile

32. The mission found that there were two key areas meriting regulatory reform regarding MMFs. The reforms identified were:

- reducing the risk profile of MMFs in order to make them less vulnerable to liquidity shocks; and
- clearly distinguishing MMFs from Fixed Income OEFs to identify the former more readily as vehicles primarily pursuing capital preservation and liquidity, and Fixed Income OEFs as pursuing primarily investment returns and liquidity transformation.

The mission team believes that these changes would make Colombia's MMF sector less vulnerable to significant redemptions across the sector, particularly during periods of distress in financial markets.

33. Colombia is an outlier compared to its regional and global peers in terms of the risk its MMFs may assume under applicable laws. The primary regulatory risk limit for Colombia MMFs is that of the weighted average maturity (WAM). WAM is a measure of the average length of time to maturity of

[23] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD770.pdf, page 23

all the underlying securities in the fund weighted to reflect the relative holdings in each instrument.[24] Applicable rules permit Colombian MMFs to assume a WAM of up to 365 days. It is notable that the equivalent regulatory limits in two regional peers, Chile and Brazil, are far lower at 90 days and 60 days respectively. Outside of the immediate region, it is also noteworthy that MMFs in the EU are not permitted to exceed a WAM limit of 60 days.

34. Colombia's MMF framework also differs in that it does not refer to the permitted weighted average life (WAL). WAL is the weighted average of the remaining life (maturity) of each security held in a fund. It is used to measure the credit risk, as well as the liquidity risk.[25] Implementing both a WAM and a WAL limit allows for liquidity, duration and credit risk of MMFs to be contained. Consequently, IOSCO advocates both WAM and WAL limits within regulatory frameworks for MMFs.

35. The impact of the higher risk profile permitted is not just a theoretical risk, but one whose impacts are observable in practice. For example, the assets held by MMFs bear a striking resemblance to those held by FI-OEFs, as explained earlier in this paper. While there will often be some level of overlap between the holdings of MMFs and FI-OEFs, with both having exposure to corporate and sovereign credit, the level of overlap resulted in a similar risk profile, which is detrimental to the resilience of the MMF sector in Colombia. For example, data provided by the SFC showed that WAM levels of Colombian MMFs actually exceeded those of FI OEFs. In practice, therefore, MMFs, which are by definition (under law and by market practice) primarily intended to be capital preservation vehicles, are operating in a riskier way than FI-OEFs, whose role is primarily to deliver investment returns via liquidity transformation.

36. The review found that the permitted risk profile of Colombian MMFs rendered them more vulnerable to a liquidity shock. This is because there is a trade-off between potential yields and liquidity in credit instruments. Consequently, MMFs generally have a disproportionately higher exposure to less-liquid, higher yielding, credit instruments, while maintaining the liquidity buffers required under applicable rules. The potential risk in the system is accentuated by the fact that Colombian MMFs' investments are concentrated in credit securities issued by a small number of Colombian financial institutions. In part, this concentration is explained by the relatively shallow capital markets in the jurisdiction. However, the mission learnt that the sovereign credit market was both relatively deep (in comparison to corporate credit) and that MMFs had very low exposure to it. While the mission is not advocating a reorientation towards sovereign credit, being neutral on the investment strategy employed, it appears that yield-seeking MMFs are highly exposed to an already concentrated and less-liquid area within the credit markets. This accentuates the risk that such funds are vulnerable to herding behavior inherent to shallower, riskier markets.

Recommendations

37. The mission recommends amending the regulatory framework to lower the risk profile of MMFs via adjustments to the WAM limit and creation of a WAL limit. While the mission did not model the likely impact of such measures on the composition of Colombian MMFs (and advocates that the Colombian authorities do so in addressing these Recommendations), it envisages that the measures

[24] https://www.iosco.org/library/pubdocs/pdf/ioscopd392.pdf

[25] https://www.iosco.org/library/pubdocs/pdf/ioscopd392.pdf

would lead to increased diversification in MMF holdings as OEF Managers look across the spectrum of credit instruments to meet risk limits. The mission has not advocated a particular WAM or WAL limit for Colombian MMFs. However, it is recommended that in the case of the WAM the level be materially lower than presently permitted, while allowing for the particularities of the Colombian markets. The mission also advocates that the timeline for any change be gradual to avoid disruption to the MMF market.

38. There is a case for the Colombian authorities to establish different categories of MMF, allowing for differing levels of risk (potentially defined by WAL and WAM) in each category. Such an approach would allow for those investors who are utilizing MMFs as a stability and capital preservation vehicle to be directed to the lowest risk options, as is appropriate. It would also allow for the segment of the market which is currently demonstrably using MMFs to seek a competitive yield, while investing in a very liquid vehicle, to be provided an appropriate option. The measure could potentially have the advantage of cushioning the impact of the reforms proposed in this section on the MMF market, as those existing MMFs with higher risk profiles could select to convert to a higher-yielding, rather than capital-preserving, MMF category. The mission team notes that similar such measures have been introduced in other markets, leading to the emergence of 'government' (lower risk) MMFs and prime (higher risk) MMFs. These informal (as distinct from regulatory) categorizations may not be applicable or appropriate for the Colombian market where sovereign debt attracts the same credit rating as credit issued by the largest financial institutions. It would be for the Colombian authorities to decide on whether separate categories of MMF are appropriate, based on an analysis of the market, and on what basis the segregation between category types be made. However, we note applicable IOSCO recommendations that "for the more conservative money market funds, the WAM should generally not exceed 60 days and the WAL should generally not exceed 120 days."[26] Given how distinct these parameters are from the current regulatory framework in Colombia, one option is to create a more conservative MMF type that more closely aligns with international standards, and another (more risky) category that would not be such a dramatic change to the status quo. Should different categories be established, rules regarding their naming conventions should be adopted in order to clearly differentiate them from each other as an additional investor protection measure.

39. Finally, while generally recommending MMFs adopt a lower risk profile, the mission also recommends that the Colombian authorities consider whether to permit MMFs to invest more than the current 5 percent maximum unhedged exposure to non-COP denominated assets. The recommendation is tempered by a recognition that any increase in the current ceiling would introduce more market risk into Colombian MMFs. The measure would therefore need to be justified by the potential increase in liquidity that access to non-COP denominated assets could bring. The recommendation comes in the context of Colombian corporate credit markets being shallow and illiquid.[27] Consequently, increasing the ability of OEF Managers to obtain exposure to liquid money market instruments denominated in foreign currencies may be an additional tool to increase liquid assets in MMFs. Any potential amendment in this area should be underpinned by a more thorough analysis of the potential impact on the MMF market by the Colombian authorities than was possible during this mission.

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[26] https://www.iosco.org/library/pubdocs/pdf/ioscopd392.pdf page 11

[27] https://documents1.worldbank.org/curated/en/099010004112241518/pdf/P17314204e921c0430aacb0c320cb7f9e13.pdf Paragraph 63

Bank Funding

40. An important aspect of Colombian OEFs, including MMFs, is the extent to which they fund Colombian financial institutions' liabilities (see paragraph 6, section I of this paper). Although this is not unusual when compared to some peer jurisdictions,[28] any change to the regulatory framework will need to consider the likely impact on bank funding, given its importance to the real economy. Reviews of peers have found that reforms to reduce vulnerabilities in MMFs have in some cases led to more expensive cost of capital for banks and reduced share prices.[29]

41. However, the changes proposed in this section could be positive for bank funding by substituting stability for quantity. This is to say that in other jurisdictions, lower risk MMFs have been shown to be less susceptible to redemption runs and therefore less likely to liquidate assets in portfolios. Given the growing importance of the MMF market in Colombian bank funding, these factors would need to be considered by the Colombian authorities when calibrating the measures recommended in this section, including their timing.

42. The review noted the striking similarity between the portfolio assets held by Colombian MMFs and other OEFs. As outlined in paragraph 17, Colombian FI-OEFs and MMFs are both substantially orientated to Certificates of Deposit issued by local financial institutions.

C. Liquidity of FI-OEFs

43. The mission team found that the Colombian authorities should explore additional measures to ensure OEFs maintain sufficiently liquid assets to meet redemptions. Some measures worthy of exploration are suggested below, including a recommendation that any policy development in this area should be proportionate, considered and gradual. This takes into account the fact that no OEF suspended during the period reviewed, including during extraordinary liquidity squeezes such as during March 2020.

44. As outlined in section I. B the liquidity strain experienced in March 2020 impacted all Colombian OEFs, MMFs, FI-OEFs and Equity OEFs. MMFs are covered in section II. B. There are no material concerns regarding the ability of Equity OEFs to meet redemptions. The ability of FI-OEFs to meet liquidity demands is, however, more of an area of focus given the shallowness of the section of capital markets in which they invest. As described in paragraph 17, Colombian FI-OEFs are, like Colombian MMFs, highly orientated towards relatively short duration local corporate credit rather than, for example, investing materially in local or foreign sovereign credit.

45. As described in paragraph 3 above, FI-OEFs are covered by strong rules requiring minimum levels of liquidity. These measures include the LRI requirement and minimum levels of HQLA. However, given these are only minimum liquidity requirements, a review into whether there are measures that could improve liquidity across the portfolio was merited.

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[28] https://www.fsb.org/uploads/P111021-2.pdf page 2

[29] https://www.bis.org/publ/work810.pdf

Recommendations

46. The mission recommends the following measures be explored by the Colombian authorities as a means of enhancing the liquidity profile of FI-OEFs:

- Complementing the LRI as a minimum level of liquidity (a 'floor') with an explicit maximum percentage of NAV capable of being invested in illiquid assets (a 'ceiling'). Under this measure, the Colombian authorities would need to define both the ceiling and the meaning of 'illiquid' with reference to the time to liquidation of portfolio assets. The mission team recommends that the Colombian authorities undertake an analysis of asset liquidity in Colombian capital markets to help determine both the proposed ceiling and the meaning of 'illiquid' in this context. We note that the draft IOSCO recommendations provide guidance on the definition of liquid, less liquid and illiquid in normal and stressed market conditions (see page 21 of IOSCO's Consultation Report on *Revised Recommendations for Liquidity Risk Management for Collective Investment Schemes*[30]).
- Rules requiring that a minimum percentage of the portfolio be made up of diversified portfolio assets (by issuer type). At present, legislation permits portfolios to be concentrated in terms of their exposure to a small number of issuers of corporate debt. This is reflective of the local corporate debt market generally being dominated by a small number of financial institutions.[31] It is also not atypical outside of larger jurisdictions for such concentration to be permitted. The Colombian authorities should assess the scope for including a minimum diversification requirement in Colombian OEFs, with due regard to their greater knowledge of the market and access to portfolio holdings data. Areas that merit inclusion in deliberations of this policy initiative are the extent to which it would result in Colombian OEFs gaining more exposure to sovereign debt compared to their current concentration in corporate debt, the likelihood of increasing OEF investment in 'nontraditional' assets and the potential impact on the current degree of common investments between OEFs and credit institutions.[32] The desirability (or otherwise) of such a reorientation would be for the Colombian authorities to determine.
- Requiring a minimum level of OEF holdings are both liquid and listed on an applicable exchange. Public listing of a security on an exchange does not denote liquidity in and of itself. However, depending on both the security in question and the exchange, it can be a material contributor to the liquidity of the security. Applicable laws presently only require that portfolio holdings be registered at the RNVE, which implies that they are tradable securities offered publicly. However, this is distinct from requiring that OEFs only invest in securities that are both listed on a public exchange and are sufficiently liquid to align with the redemption terms of the OEF. Caution is advised regarding this measure, as it would likely have an impact on investment decisions by OEF Managers. For example, it could incentivize some portfolios to reorientate some exposure away from corporate credit to listed sovereign debt. Such a reorientation may not even be permissible under all FI-OEFs' prospectuses, so this measure would need to be considered carefully by the Colombian authorities.

47. It is appropriate to leave room for the Colombian authorities to specify and calibrate the policy initiatives proposed in this section. The mission team is of the view that enhancing the liquidity

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[30] CR/06/2024 Revised Recommendations for Liquidity Risk Management for Collective Investment Schemes - Guidance Document

[31] https://documents1.worldbank.org/curated/en/099010004112241518/pdf/P17314204e921c0430aacb0c320cb7f9e13.pdf, paragraph 63

[32] https://repositorio.banrep.gov.co/server/api/core/bitstreams/bde7c405-44be-4b39-bf04-406d32a191f8/content, pages 44-45.

of FI-OEFs is not as high priority as other matters explored in the mission, such as reducing the risk profile of MMFs, and the absence of a suspension in any FI-OEF during the review period reinforces this view. It should also be recognized that there are no simple solutions, and each policy option outlined involves trade-offs with inherent advantages and disadvantages. However, the Colombian authorities should nonetheless duly consider the measures proposed, bearing in mind the FI-OEF sector is particularly orientated to investments in credit markets lacking depth and vulnerable to changes in investor sentiment. Any reduction in the FI-OEF sector's liquidity vulnerabilities will serve to enhance trust in the sector, which ultimately is likely to contribute to its growth.

D. Liquidity Management Tools

48. Liquidity management tools (LMTs) are defined by IOSCO as measures available to CIS, both on a day-to-day basis and during stressed market conditions, that alter redemption conditions. Their prominence has risen in international discussion regarding improving CIS liquidity, particularly as other areas (addressing mismatches between CIS assets and liabilities) reach a natural plateau in policy development. The mission team understands from the Colombian authorities that under applicable laws, LMTs may be applied in Colombian CIS. However, at present no CIS has availed itself of the right to include LMTs in its prospectus. One explanation for this is that there may be a lack of clarity in the market regarding their ability to use these tools. At present, the regulatory framework is silent on whether LMTs may be utilised by OEFs, indicating additional clarity is merited.

49. The regulatory framework should be amended to ensure clarity regarding the LMTs available to OEF Managers. Suggestions on the LMTs of most relevance and use to the Colombian market are set out below. It should be noted that, while LMTs are an additional component of an OEF Manager's toolkit to help manage liquidity, they rarely substitute for the core factor which underpins liquidity in a CIS i.e., that the liquidity of the portfolio holdings matches the liabilities to which the CIS is subject. For this same reason, the recommendations in this section have a lower priority in the overall analysis. Furthermore, we have not suggested that application of LMTs be made mandatory, as there may be circumstances where the use of LMTs is not appropriate.

50. While a range of LMTs exist, the mission team believes those focused on seeking to address the risk of 'first mover advantage' by institutional investors would be most relevant to the Colombian market. The following LMTs are highlighted as meriting specific inclusion in the regulatory framework:

- *Share classes with notice periods (meaning delayed fulfilment of the redemption request).* These types of share classes can be specifically targeted towards one investor type which, by virtue the large size of their investment compared to other unitholders, represents a larger risk on the liabilities side of the OEF's balance sheet. The mission team learnt that in Colombia, institutional investors are often very sensitive to economic and political developments affecting the investment landscape. In practice, this leaves OEFs vulnerable to swift redemptions amounting to significant portions of the NAV. Utilizing this LMT allows OEF Managers to require only those investors that represent a material risk to OEF liquidity to provide notice of their intention to redeem. This allows other investors, more likely retail investors (investing smaller amounts, and representing a lower liquidity risk to the OEF) to have confidence that they can access their capital upon request.

- *Gates (i.e., partial and temporary restrictions to investors' ability to redeem their capital, generally on a pro-rata basis, that aim to spread redemption requests and asset sales over time in the best interest of all investors).*
  In comparison to notice periods on certain share classes, gates can be applied to all unitholders redeeming. Consequently, they can be a signal to external stakeholders that liquidity may be declining in a CIS. There are therefore negative reputational consequences for OEF Managers applying a gate that may impact their application in practice. Nevertheless, they can be a useful tool to avoid going as far as suspending a CIS (which has even more negative reputational consequences)
- *Minimum balance at risk (where a fraction of each investor's shares (MBR shares) cannot be redeemed immediately)*[33]
  Minimum balance at risk is a relatively newly LMT proposed by such bodies as the FSB. The measure can reduce the phenomenon of first mover advantage by ensuring that an investor continues to have 'skin in the game' in the OEF's liquidity, insofar as it is not incentivized to remove all liquidity from the OEF because it may not redeem all of its holdings at once. It is distinct from a gate in that it is a permanent feature of dealing in an OEF, rather than being applied by an OEF Manager in, for example, a time of liquidity distress. It therefore has less negative reputational impact. As a relatively newly proposed LMT, the Colombian authorities would have the disadvantage of not being able to benchmark its implementation in other jurisdictions, in order to help to apply lessons from implementation of the new measure. The Colombian authorities may wish therefore to monitor peers' integration of this tool within their regulatory frameworks first before seeking to implement this measure.

51. It is important to manage expectations regarding the likely impact of these tools on OEF liquidity. Firstly, inclusion of these LMTs in fund prospectuses ideally would not be forced upon OEF Managers; rather, their explicit inclusion in the regulatory framework clarifies their potential inclusion in OEF Managers' toolkits. OEF Managers would therefore need to assess whether application of these tools would be in the best interests of their clients. For example, as IOSCO has noted regarding anti-dilution tools, certain investors may prefer not to invest in OEFs which apply such tools. The same intuition is true for all LMTs. In the case of Colombian OEFs, some investors may perceive share classes with notice periods as akin to a CIS with permanence, and refrain from investing. Such a circumstance would be consistent with IOSCO's above-noted concerns on LMTs, and underlines why LMTs cannot be the primary tool to address liquidity in an OEF.

52. The authorities, particularly the SFC, can encourage OEF Managers to include LMTs in their prospectuses, and the mission recommends that they do so (although this is distinct from obliging LMTs be utilised). However, the recent removal of the requirement of the SFC to authorize a fund prior to its establishment means that there is limited bandwidth to require new funds to include LMTs within their prospectuses as a condition of their authorization. The Colombian Authorities will need to consider how to address this, potentially through increased monitoring and post-implementation reviews, and regulatory/supervisory guidance and industry interaction may be required. The mission team further suggests that the Colombian authorities engage with regional peers, such as fellow members of IOSCO's

[33] https://www.fsb.org/uploads/P300621.pdf page 30

Inter-American Regional Committee or its Growth and Emerging Markets Committee, to benefit from their experience of implementation of regulatory frameworks for LMTs.

53. **Not all LMTs may be suitable for all types of OEFs.** For example, it is questionable whether share classes with notice periods and gates should be LMTs available to MMFs. The credibility and integrity of the MMF ecosystem rests to a large extent on the ability to redeem upon demand – hence to emergence of the sector as a distinct form of CIS. MMFs thus differ from other OEFs, where inherent in the desire for investment returns is both acceptance of market risk and maturity transformation. Reducing the risk profile and increasing the liquidity of portfolio holdings should therefore be the primary means by which the Colombian Authorities seek to reduce vulnerabilities in the MMF sector. Finally, given the novelty of minimum balance at risk as an LMT, it is also yet to be seen whether it will be acceptable to investors in MMFs in particular.

54. **Finally, the mission recommends that the Colombian authorities explore whether to allow fund managers to be able to unilaterally adjust down the value of certain portfolio holdings during periods of valuation uncertainty**. Valuation is a separate area to LMTs, but closely related, so it is included in this section. At present, OEFs are required to value assets on a mark-to-market basis, using a third-party price provider. This is good practice, but it can become challenging – particularly in stressed conditions in markets with shallow liquidity, such as the corporate debt markets in which the majority of Colombian OEFs invest. The mission team understands that during such periods, the third-party price provider can make a subjective assessment of an asset's likely value, based on the last traded prices, and that OEF Managers may challenge the figure provided.

55. **The mission recommends the Colombian authorities assess whether there are circumstances where this process may still lead to overvaluation of assets, to the detriment of remaining investors in the OEFs (and the benefit of redeeming investors).** For example, where there is new and material uncertainty regarding the creditworthiness of an issuer of a corporate credit instrument, this may not manifest itself in the traded values of the instrument because the market is so shallow. Nevertheless, there may be sufficient information to reasonably take a haircut on the previously quoted value of the asset.[34] This is relevant to OEF liquidity because some investors, particularly institutional ones, are likely to be far more cognizant of the composition of OEFs' portfolios and regarding matters such as uncertainty regarding individual assets' true values. At present, the current framework provides an incentive for such investors to redeem prior to that uncertainty crystallizing in the form of lower valuations when the asset in question is traded (either in the market, or specifically by the OEF). This an example of first mover advantage, and an incentive to drain liquidity from an OEF. Allowing OEF Managers to mark down asset valuations in limited circumstances can be an important measure to mitigate these circumstances.

56. **Any ability to adjust asset valuations would likely require measures within the regulatory framework to ensure that it is not abused to the detriment of redeeming investors.** For example, during a period of liquidity stress, there is an incentive for an OEF Manager to abuse the discretion by marking down the values of portfolio holdings, as doing so will provide a disincentive to investors to redeem. This can be mitigated within the regulatory framework, such as by requiring an OEF Manager to

[34] When there are relatively few transactions in a specific asset, OEF managers tend to use proxies e.g., by looking at how an asset's value dropped in comparable market conditions in the past.

correct any error in the value of the OEF (known as a pricing error). In the circumstances described this can mean cash transfers to investors who redeemed at too low a value. Another control worthy of consideration is placing a maximum ceiling on the percentage of NAV that can be marked-down, or on the maximum percentage haircut an OEF Manager can unilaterally make on an asset-by-asset basis. As with the other measures in this section, the mission team recommends that the Colombian Authorities proceed gradually and cautiously with this regulatory change to help mitigate the risks inherent in its poor execution by OEF Managers.

E. Interagency Liquidity Working Group on OEFs and Development of Risk Appetite

57. **The mission team recommends establishing an inter-agency working group to address the recommendations contained in this paper.** This working group should be composed of representatives from at least BanRep, the SFC and the URF. The recommendation for an inter-agency approach arises because this issue impacts various agencies at different levels. For example, BanRep from a financial stability perspective, SFC as the financial services regulator and having an investor protection remit, and the URF as responsible for preparing and adopting regulations. Furthermore, there are trade-offs involved in the proposals included in this paper which would impact the agencies differently. For example, policy proposals on MMFs could lead to a reduction in investor protection risks but an increase in the cost of funding for local financial institutions, at least initially. These trade-offs impact the scope and remit of the aforementioned agencies distinctly, and therefore any policy response would benefit from their collective buy-in, or their collective determination of priorities. Each agency's area of expertise would also likely enhance the effectiveness of the working group. For example, the SFC collates data on fund holdings and is closer to the practical impact of the regulatory framework on market participants, while BanRep conducts broader macroeconomic and financial stability analysis, and the URF has expertise on the legislative framework. The working group could also serve as the primary point of contact for industry interactions regarding potential changes to the regulatory framework, including discussions on timing and implementation.

58. **The remit for this working group should include not only establishing, from a cross-agency perspective, whether the recommendations contained in this paper be adopted (and how), but also their timed implementation.** It is notable, for example, that the regulatory framework for OEFs was subject to material amendment in 2024. The Colombian authorities may therefore not deem it appropriate to undertake significant regulatory change again in the short-term. Similarly, while this paper includes the proposed prioritization and proposed timing for implementation of the recommendations, ultimately these are matters that are for the Colombian authorities to determine.

59. **Establishing a cross-agency risk appetite is essential for determining the appropriate approach to implementation of the recommendations outlined in this paper.**[35] The mission team believes that an effective policy response to OEF liquidity issues requires a determination of institutional priorities, because trade-offs (and therefore difficult choices) are an inherent part of those policy decisions. As suggested above, this is also because the agencies involved in the institutional framework

[35] In this context, the authorities could usefully take into account the FSB's Principles for An Effective Risk Appetite Framework, 2013.

governing OEF liquidity, and the financial stability issues arising from it, have differing institutional remits and objectives that require alignment when working on a cross-agency basis. International standards could be referenced to help establish key components of the risk appetite, such as an internal risk appetite statement.[36] Alignment of these priorities would amount to a cross-agency risk appetite concerning OEF liquidity. The mission team believes that the following matters should be included in the risk appetite established in response to the recommendations:

- *Policy regarding BanRep's openness towards extending repurchase agreements for OEFs regarding corporate credit.*
  The mission team learned that BanRep's decision to extend its repo operations from sovereign debt instruments to corporate debt was a material factor in providing liquidity to OEFs during the March 2020 liquidity squeeze. Furthermore, discussions with market participants, including some OEF Managers, indicated support among those participants for this practice to be undertaken whenever liquidity dries up in the corporate debt market in order to ease systemic risk from OEFs not being able to meet redemptions. However, the practice is not without risk on behalf of the Colombian authorities. One such risk relates to moral hazard. The decision of OEF Managers to invest so heavily in domestic corporate credit, rather than more liquid markets such as sovereign debt, is their own choice, which would usually have consequences. Moral hazard occurs where OEF Managers can benefit from investing in less liquid markets, but do not suffer the reputational consequences of failing to meet redemptions, such as when benefitting from central bank intervention to repo those less liquid assets. Central bank intervention may be fairly normal during financial crises, but determining what constitutes a 'crisis' alone can be a subjective matter and the market may have a different interpretation to BanRep. This difference can influence asset allocation by OEF Managers. Furthermore, BanRep's risk appetite on intervention will need to align with other authorities' policymaking priorities regarding OEF liquidity to be effective. For example, when deciding the extent to which the Colombian authorities wish to meet the recommendation in this paper regarding the derisking of the MMF sector, due regard will need to be paid to BanRep's appetite to repeat (or not) the repo arrangements that benefitted the sector in 2020. It is feasible, for example, that an extended delay to reforms in the MMF market could lead to a need for BanRep to adjust its risk appetite in the short term and look to adjust it over the longer term to match that reform cycle.
- *Policy regarding Colombian financial institutions access to cheap funding from the OEF market.*
  This report has already noted that Colombian capital markets are not deep and issuers are principally composed of local financial institutions. Further, the heavy exposure of the OEF market, including local MMFs, likely offers a source of cheaper funding for those financial institutions than other sources (such as foreign investors). It has also been demonstrated in other jurisdictions that MMF reform to derisk the sector has led to a higher cost of capital for some financial institutions. The trade-off between derisking the MMF sector for the purpose of promoting financial stability and alternatively maintaining current policy, allowing the proliferation of cheaper bank funding, is a question of preference for the Colombian authorities. As suggested earlier in this paper, an additional factor to consider is the possibility that financial institutions will benefit from increased stability of funding, as a result of the derisking of the sector. However, this is not assured.
- *Policy regarding growth of the Colombian OEF sector, and the resulting trade-offs.*

[36] https://www.fsb.org/uploads/r_131118.pdf

AUM in the Colombian OEF sector has been growing materially in the past decade, which is likely a positive for local capital markets and allocation of capital in the Colombian economy. Regulatory reform, such as some of the reforms advocated in this paper, can place additional burdens on market participants, including OEF Managers. It can reduce the growth of the number of products as well as the number of market participants providing such products. Given the need develop local capital markets, there can be good reasons to alleviate any perceived burden of frequent regulatory change or enhancement of regulatory requirements. However, there is a trade-off to avoiding placing more burdens on the OEF sector. It is apparent to the mission team that the current framework does place material onus on the SFC, particularly the supervision function. This is because the burden of closely monitoring the sector and ensuring that OEFs are not experiencing liquidity issues falls on the regulatory authority. This obligation appears to have increased since regulatory reforms to allow OEFs to establish without going through ex ante authorization by the SFC. Ultimately, the decision over whether to prioritize sectoral growth or oversight is one of preference and for the Colombian authorities to assume.

60. Communication to stakeholders regarding regulatory authorities' risk appetite can take many forms, and there are international examples that can be referenced.[37] One way of communicating regulatory authorities' risk appetite can be on an issue-by-issue basis by way of consultation with industry on regulatory reforms. For example, in the UK the FCA communicated the Financial Policy Committee's policy preference that "MMFs should be able to withstand severe but plausible levels of investor outflows without amplifying stress and increasing risks to financial stability" within a Consultation Paper.[38] Indeed, policy change can itself be the articulation of a risk appetite to the market. Globally, the significant reforms made to MMFs have been a strong signal of policymakers' view that such funds should be sufficiently capable of withstanding shocks themselves, avoiding the need for additional support.

[37] The FCA's approach to preventing 'harm' is one such example: https://www.fca.org.uk/publications/corporate-documents/our-approach-to-supervision. The Toronto Centre has also published on this topic: https://www.torontocentre.org/index.php?option=com_content&view=article&id=96&Itemid=99

[38] https://www.fca.org.uk/publication/consultation/cp23-28.pdf, paragraph 2.46

Conclusion

61. **The mission acknowledged the overall liquidity of the Colombia OEF sector, with no fund suspensions during the period reviewed, including during a period of extraordinary redemptions in early 2020.**

62. **It is making a number of recommendations focused on adding to the resilience of the OEF sector and the supervision of it by the Colombian Authorities.** These recommendations seek to reduce vulnerabilities regarding liquidity in MMFs and the wider OEF sector. There are five recommendations made across a range of issues.

63. **The most significant of these are the recommendations to materially reduce the risk that MMFs are permitted to adopt under applicable laws, and developing a cross-agency taskforce to address this report and establish a risk appetite regarding OEF liquidity.** Colombian MMFs are outliers compared to regional and global peers regarding the risk they are permitted to undertake, which leaves them particularly vulnerable to redemption risk when markets move. Their risk profile does not align with their supposed status as vehicles for capital preservation and stability. Meanwhile, and bearing in mind the recent material changes to applicable rules and laws in the OEF sector and the likely desire to approach any further regulatory change gradually, establishing a cross-agency risk appetite will help navigate the trade-offs that will need to be made as the Colombian Authorities choose the appropriate course of action.