Executive Summary

In the first half of 2010, the Colombian economy continued to consolidate the recovery that it had been experiencing since the third quarter of 2009. This greater strength has occurred in a context of rising prices for commodities, better expectations for world growth as well as increments in the levels of risk aversion. Locally, the outlook of both consumers and firms with respect to the future performance of the economy is positive. As a result, more momentum in intermediation can be expected.

In the first half of 2010, the total loan portfolio showed an annual real growth of 3.2%, higher than what had been reported in the previous six months (0.4%). This dynamism is mainly explained by the performance of the mortgage portfolio and consumer loan portfolio (19.2% and 6.2%, respectively). The commercial loan portfolio, in turn, showed an annual real expansion of -0.3%, although in the most recent six months its average growth has been positive (2.5%). The recovery of the loan portfolio has been accompanied by better levels of quality in spite of the fact both commercial and microcredit loan portfolio have deteriorated. With respect to liabilities, it is important to emphasize the fact that the growth rate for deposits declined (4.2% in June, 2010 compared to 5.8% in December, 2009) and that the shift from certificates of deposit (CDs) to demand deposits continued. This is primarily due to the low level of interest rates, larger bond issues on the part of the financial system and to the elimination of remuneration for reserve requirements on CDs, among others.

Non-banking financial institutions (NBFI) continued to build up their investment portfolio in spite of the slowdown shown in their rate of growth (going from 25.5% in December, 2009 to 18.1% in June, 2010) as a consequence of the lower earnings from valuation. With respect to the composition of their portfolios, it is important to highlight the fact that all of the NBFIs added to their positions in public debt securities in the first half of 2010. In addition, in the first few months of the coming year, the multifund plan for pension fund managers will go into effect. This draws our attention to the way these entities could restructure their investment portfolio and which could possibly affect the prices of financial assets.

With respect to the financial system risks, an increase was seen in the TES positions for both the credit entities and the NBFIs, which raises their exposed balance. However, the reduction in the volatility mesures of TES prices in the last six months has mitigated the effect on the market risk for the financial intermediaries. It is worth pointing out that this stability in volatility does not mean that there will not be increases in price volatility for the portfolios of the financial intermediaries in the future. Credit risk has also improved for the entire system. However, the latest loan portfolio harvests must be highlighted because of the fact that they are better in comparison to those of the recent credit boom (2006-2007). This is in spite of the deterioration in the harvests of microcredit during the second quarter of the year in progress. With respect to liquidity risk there has been an increase primarily due to the fact that there has been a restructuring towards more volatile short term liabilities on the part of credit establishments. Nevertheless, stress tests show that the entities could endure an adverse situation that affects their liquidity positions.

In general, credit institutions have shown positive results over the course of the year. Profits grew at an annual real rate of 8.3% in June, 2010 and capital adequacy is at levels that are well above (13.5%) the regulatory minimum (9%). In spite of the fact that risks remain at moderate levels and that both quality and delinquency ratio have dropped, greater strength in intermediation activities should be accompanied by constant monitoring of the risk indicators to prevent adverse changes from affecting the stability of the financial system.

Finnally, in the months following the period that this report analyzes, there has been an increase in the inflow of capital to the private sector reported by the foreign exchange balance, specifically in the area of private sector net foreign indebtedness. The analyses done by the Banco de la República indicate that, so far, these operations have not caused a significant increase in foreign exchange risk for any agent in the economy. This is derived from the relatively low level of operations, the natural hedging of some companies and the transfers and reassignments of risk done through the derivatives market.

Board of Directors of the Banco de la República

Financial Stability Report

Prepared by:
The Financial Stability Department of the Monetary and Reserve Division

One of the duties of Banco de la República, as stipulated in the Colombian Constitution and in Law 31/1992, is to ensure price stability. Doing so depends largely on maintaining financial stability, which is understood as a situation in which the financial system is able to broker financial flows effectively. Financial stability contributes to better resource allocation, which is important to preserving macroeconomic stability. For that reason, financial instability has a direct impact on macroeconomic stability and on Banco de la República's capacity to fulfill its constitutional mandate. In short, monitoring and maintaining financial stability are crucial to that activity.

Banco de la República provides for financial stability in a variety of ways. To begin with, it makes sure the payment system in the Colombian economy operates properly. Secondly, it extends liquidity to the financial system through its monetary transactions and by exercising its constitutional faculty as the lender of last resort. Thirdly, being the country's credit authority, it designs financial regulatory mechanisms to reduce episodes of instability. It does so in conjunction with the Superintendencia Financiera de Colombia.(Financial Superintendence) Moreover, Banco de la República carefully monitors economic trends that could threaten the country's financial stability.

The *Financial Stability Report* is part of this last task and accomplishes two objectives. First, it describes the recent performance of the financial system and its principal borrowers. This is done so future trends in that performance can be visualized. Secondly, it identifies the major risks to credit institutions. The reason for both these objectives is to inform the public of the trends and risks that can affect the financial system as a whole.