

EXECUTIVE SUMMARY

On the international scene, the prospect for lower growth and the fears about the sustainability of the public debt that some European economies have raised the risk perception and, therefore, the uncertainty and volatility of the international financial markets. In spite of the fact that the risk perception remains at low levels for the Latin American economies, their capital markets have been affected by the greater aversion to risk. Nevertheless, the domestic situation in Colombia has continued to show positive performance so far in 2011. The GDP for the first half of the year showed a growth rate of 5.2% driven by household consumption and private investment in machinery and equipment. Furthermore, exports grew a real 11.5% due to both rises in prices and increases in quantity and direct foreign investment grew at an annual rate of 75%, especially because of what has happened in the mining sector.

This strength in the real sector continues to boost the intermediation activities that are still showing a strong performance. The gross portfolio maintained its growth trend in the first half of 2011, which translates into a real annual increase of 18.9%. The consumer loan portfolio showed the greatest strength as it registered a real, annual variation of 20.6%. The commercial loan portfolio, which had shrunk slightly between May and June, grew 19.9% and the housing loan portfolio with securitizations grew at a stable rate of a real, annual 13.5%. Regarding liability accounts there has been a significant growth in bonds (52.9%), interbank loans (41.6%), and in deposits, especially in checking and savings accounts (15.6% and 20% in each case).

With respect to credit risk there was an improvement in the quality indicator for all of the types of loan portfolios with the exception of micro-credit. For the consumer, commercial and housing loan portfolios, this indicator was at 7.5%, 7.1%, and 6.3% respectively while the one for micro-credit came to 7.4%. Likewise, the default indicator has seen a stable performance for all of the types of portfolio and is at 3.1% for the total loan portfolio. Last of all, the fact that the coverage indicators have remained stable for the first half of the year is emphasized.

The investment portfolio of the credit establishments and non-banking financial institutions (NBFI), in turn, showed an increase of \$6.1 t and \$1.8 t respectively. The NBFI showed a restructuring towards public debt securities in their portfolios which reduced the share in real sector and financial assets at the same time that the share in longer term securities rose. The motivation for this was the devaluation of the national variable income securities which led to lower levels of profitability for these entities than what had been seen in 2010. With respect to the investments belonging to commercial banks, the proportion of securities that are tradeable and available for sale were found to have risen 4.8% between February and August 2011.

As a result, the exposure to market risk has risen for all of the types of financial entities due to the increase in the exposed balance and the duration of the portfolios. However, the materialization of market risk has been limited because of the limited volatility in the prices of their securities in the last few months. Given their business structure, entities such as pension fund managers and stock market brokers could be the ones affected the most due to adverse shocks in the financial markets.

When liquidity risks are analyzed, financial entity holdings of public debt securities have been found to be sufficient to deal with possible adverse shocks on their sources of funding. Nevertheless, there has been a declining trend in the liquidity indicator in the last few quarters which could be explained by an increase in the share of liabilities with cost. In addition, there has been a slight decline in agent interconnection in the public debt market which indicates that the system has less resistance to liquidity shocks.

In conclusion, during the first half of 2011, the financial system continued to show expansion represented by the increase in the credit institutions' gross portfolio and stable levels of profitability. This expansion of lending has occurred in a scenario of stress in the international environment. As a consequence, it is important to do continuous, strict monitoring of the quality of the financial assets as well as the changes in the prices of loan portfolio securities.

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.