

EXECUTIVE SUMMARY

The Colombian financial system experienced a drop in the value of its tradable securities during the first half of the year, owing to the volatility of domestic financial markets at the time. Associated in part with the uncertainty perceived on international financial markets (and even more so in Colombia), this volatility occurred despite the positive trend in Colombia's productive sector.

That episode had a number of repercussions for credit institutions. To begin with, the drop in the value of tradable securities prompted somewhat of a shift in the assets held by these institutions. The loan portfolio accounted for 55% in June, while investments had declined to 28%. The respective figures in December 2005 were 50% and 32%.

In June, the annualized profits for credit institutions as a whole were down by 4.4% compared to the same month in 2005, primarily because of losses on investments in the tradable portfolio. This drop in profits reduced the system's asset profitability to 2.3% (0.5 percentage points (pp) less than in December). These difficulties also affected a good many non-bank financial institutions, since their portfolios are heavily exposed to changes in the valuation of investments in domestic government bonds.

This set of events constitutes materialization of the market risk facing credit institutions, a situation that was stressed repeatedly in previous editions of the *Financial Stability Report*. Consequently, for reasons concerning the stability of the financial system, it is important to underscore what the Office of the National Superintendent of Financial Institutions has done to measure and regulate market risk for institutions with a portfolio of tradable securities. Continuing this initiative in the years ahead will make the system more capable of dealing with such losses, especially with respect to its capital positions.

Traditional financial brokerage activities, on the other hand, continued to expand. Above and beyond the portfolio as a whole (19.3% real annual growth at June), an important highlight was the strong increase in consumer loans (41.2%), and the recovery in commercial and mortgage loans (15% and 1.6%, respectively). Growth in the loan portfolio was supported by a favorable increase in sources of funding used by establishments (real annual growth in deposit taking was 13.4% at June), their capital soundness, the good quality of their loan portfolios and high coverage for the riskiest loans, coupled with the recent stability in interest rates on loans of all types. As to this last aspect, it is important to note that the volatility witnessed on markets for tradable securities had no appreciable effect on the stability of these rates.

The positive situation and optimistic outlook for households suggests brokerage activities will continue to expand. However, it is important to keep an eye on the high growth rate of consumer

loans, especially after the slight recent deterioration in the quality of that portfolio. The good trend for households is complemented by growth in the private corporate sector (towards which most of the financial system's exposure is directed). Based on information available at December 2005, recent trends in the private corporate sector's indebtedness to the financial system continue to suggest that companies are more and more willing to finance working capital with their own resources.

In short, financial brokerage activities continued to increase, even if the recent volatility in tradable securities markets has affected the portfolio and financial performance of institutions. This expansion suggests that efforts to monitor and measure the credit risk posed by growth in the loan portfolio need to be stepped up. If the conditions that allowed for this growth continue, so would this expansion. Nonetheless, it is important not to forget that a change in those conditions could accelerate deterioration in the quality of the loan portfolio.

In addition to materialization of the market risk mentioned earlier and the good quality of the loan portfolio, the recent increase in liquidity risk is an important aspect to watch, even though it remains low. Limited concentration in the government bond market is a contributing factor in this respect, and Banco *de la República* has been cooperating with the Office of the National Superintendent of Financial Institutions on the design of new and better ways to measure, monitor and regulate liquidity risk.

Board of Governors
Banco de la República