

EXECUTIVE SUMMARY

The year 2010 was one of economic recovery on the global level. The worldwide economy grew at a rate that was close to 5% annually, a figure that is higher than had previously been expected by the market. The rise in the prices for commodities together with the higher degree of risk aversion with respect to the developed economies as a consequence of their slow rate of expansion contributed to a significant flow of capital towards emerging economies. In Colombia, the high terms of trade, the improvement in the confidence levels and the favorable conditions of financing led to a rapid recovery of output growth, fueled especially by investment and consumption. The above also contributed to the recovery of traditional intermediation activities after the slowdown in lending that occurred as a consequence of the international crisis of 2009.

Intermediation activities showed a positive trend over the last year and it is expected that they will continue to do so given the better performance of the economy. All of the types of loan portfolios grew moderately in 2010, which translates into a real annual increase of 13.1% of the gross loan portfolio. This growth was mainly due to the commercial and consumer loan portfolios, which rose 17% and 12.7% respectively. It is worth emphasizing the fact that housing loans with securitizations also saw a positive performance (12.7%). However, due to an important securitization process towards the end of last year, the non-securitization portfolio presented a real reduction of 2.4%. The liability side of the balance was based on the growth of deposits, especially those in checking and savings accounts (15.6% and 15.4% respectively). The increase in bonds issued by financial entities, which grew 44.8% in 2010 also stands out.

The credit institutions and the Non-banking Financial Institutions (NBFI) increased their investment portfolio significantly in 2010 (18.9% and 19.3% respectively). This portfolio is still concentrated in public debt securities and stock which translates into a higher level of potential exposure to market risk for these institutions. However, the shorter duration of the NBFI portfolio should be emphasized. This makes it less sensitive to adverse changes in market conditions. Moreover, it should also be mentioned that, in the second half of 2010, market risk did not materialize due to the low volatility in the market.

With respect to liquidity risk, holdings of more liquid assets such as the public debt securities have made it possible for credit institutions to count on the necessary resources to take care of possible adverse shocks to their sources of funding. Regarding credit risk, the quality and default indicators have continued to diminish in spite of the surge in the rate of growth for the loan portfolio. In particular, the loan portfolio quality index (risky loan portfolio/gross loan portfolio) went from 9.3% to 7.8% between June and December 2010 while the default index (nonperforming loan portfolio/gross loan portfolio), which represents the materialization of risk, went from 4.4% to 3.2% in the same period. Last of all, emphasis must be made of the fact that the higher levels of the gross loan portfolio have gone hand in hand with not only a better quality of this loan portfolio but also better hedging of the risky portfolio.

To summarize, the Colombian financial system has gone through an important consolidation process that has translated into better growth of the loan portfolio, better levels of quality and capital adequacy, stable profitability and a moderate exposure to the different risks over the last year. However, it should be mentioned that, in times of expansion, it is necessary to keep up constant, strict monitoring of the changes in prices and quality of the main financial assets in order to prevent possible imbalances that could lead to instability in the system.

Board of Directors
Banco de la República
(Central Bank of Colombia)

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.