

EXECUTIVE SUMMARY

During the first semester of the year, a weak global demand, a fall of export prices in some countries and a low investment dynamic led to reduced growth forecasts for most Latin American and the Caribbean economies. In contrast, the Colombian economy shows signs of soundness, and growth in 2014 is expected to be at or above 2013 levels, which has been reflected in variable-yield securities valuations. As for the public debt market, a flattening of the yield curve was noted, partly in response to an increase in *Banco de la República's* (the Central Bank of Colombia) benchmark rate.

Regarding credit institutions' asset accounts, the gross loan portfolio growth remained stable and the investments one decreased. Consequently, the assets share of the latter was reduced. On the liability side, composition showed no substantial changes, with savings accounts, fixed term certificates of deposits (CDT in Spanish) and current accounts being the deposits with the greater participation. In terms of profitability, returns on assets and equity on assets stabilized as a result of a better dynamic recorded by profits, after both indicators had shown a decreasing trend since June 2013.

At the end of the first half of 2014, the non-banking financial institutions investment portfolio mainly consisted of government bonds. This portfolio's balance increased compared with that observed in December 2013, mainly driven by the performance of the portfolios managed by pension and severance fund managers and trust companies. These went from recording losses to having profits, leading to an increase of the non-banking financial institutions' profitability indicators.

Between June 2013 and December 2014, credit institutions' exposure to their debtors increased, mostly due to higher household debt. This was accompanied by higher financial burden levels, so the proportion of income that households had to use for debt servicing was higher than that observed during 2013. Expectations and purchase intent indicators remain at high and positive levels, and the financial burden is at its highest so far this century.

On the other hand, private corporate sector's debt as a proportion of the GDP increased. Loans with domestic financial institutions were its main source of funding, followed by loans with foreign institutions and bonds. For the studied sample of the private corporate sector, financial indicators to December 2013 show a good liquidity situation, a greater assets growth and lower levels of credit risk. However, this was accompanied by lower profitability, increased debt and financial burden rises.

The exposure to market risk declined for credit institutions, while it increased for non-banking financial institutions due to higher public debt balances in their portfolios and an increase in their duration. This increase in duration makes value to be more sensitive to rate changes. Thus, by assuming an increase of 400 basis points on the TES zero coupon curve, it is found that losses for non-banking financial institutions caused by the shock would increase compared to six months earlier, and would decrease for credit institutions. Meanwhile, calculation of the maximum probable loss in the financial system's portfolio recorded a reduction during the semester because of lower market volatility.

In terms of credit risk, the loan portfolio default indicator increased and the quality one decreased. When assessing the system's soundness given an adverse macroeconomic shock, it was found that loan portfolio deterioration affects the profitability and solvency ratio levels, Although the latter reaches to a value above the regulatory minimum. Otherwise, credit institutions have shown a lower liquidity level, mainly explained by banks performance. Nevertheless, this indicator continues reaching higher levels to those required by regulation, even in hypothetical low liquidity levels scenarios.

When performing a joint risk analysis, it can be concluded that the situation of the financial system is one of soundness. On the one hand, the prospective analysis of possible fragility situations in the banking system, suggests that the probability of experiencing an exceptional risk scenario is low. Likewise, the systemic risk indicator confirms that the financial system does not have high levels of contemporary stress. Finally, the financial stability index results indicate deterioration in the financial system's situation as a result of lower liquidity levels; nevertheless, the aggregate index remains at favorable levels regarding the historical average.

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FINANCIAL STABILITY REPORT

Written by:
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Under the mandate given by the Constitution of Colombia, and according to regulations by Law 31 of 1992, *Banco de la República* (the Central Bank of Colombia) is responsible for ensuring price stability. Proper completion of this task crucially depends on maintaining the financial stability.

Financial stability is understood as a situation in which the financial system efficiently intermediates financial flows, contributing to a better allocation of resources and, hence, to the maintenance of macroeconomic stability. Therefore, financial instability directly affects macroeconomic stability and *Banco de la República's* capacity to fulfill its constitutional mandate, which highlights the need to promote the monitoring and maintenance of the financial stability.

The tasks that *Banco de la República* carries out in order to promote financial stability are the following: first, the Bank is responsible for ensuring the proper functioning of the Colombian economy payment system; second, it provides liquidity to the financial system through its monetary operations and making use of its constitutional feature of lender of last resort; third, the Bank contributes, together with the Financial Superintendence of Colombia, and within its credit authority functions, in the design of financial regulatory mechanisms to reduce the incidence of episodes of instability; and finally, *Banco de la República* exercises a careful monitoring on the economic trends that may threaten financial stability.

The Financial Stability Report is in the framework of this last task, serving two purposes: first, to describe the recent performance of the financial system and its main debtors, in order to visualize future trends around this behavior and, second, to identify the major risks faced by credit institutions. With these goals, it is purported to inform the general public about the trends and risks related to the financial system as a whole.