Executive Summary

The downturn in the increase in financial activity witnessed since 2007continued during the first half of the year. The economic slowdown, the country's monetary policy, and better selection practices for granting loans help explain the performance of this sector.

The lower growth rate registered in June 2008 for the total gross loan portfolio(13.3% real annual growth as opposed to 22.6% a year earlier) is largely due to the dynamics of the consumer loan portfolio and, to a lesser extent, to the commercial loan portfolio (despite its recent rebound). The consumer loan portfolio increased by 13.7% and the commercial loan portfolio by 12.7%, in real terms. These are lower than the figures reported a year ago (36.9% and 17.3% respectively). Growth in the mortgage loan portfolio has remained relatively stable (7.73%). The slowdown in traditional financial intermediation activities was accompanied by deterioration in indicators of arrears and loan portfolio quality. However, the quality indicator for new loans; namely, the one that measures loans granted during the first half of 2008, has improved compared to the same indicator in past years.

The expansion in the loan portfolio was funded primarily by an increase in deposits (7.5%), in real terms. This growth, in turn, was fueled basically by term deposits (CDT in Spanish), which rose at a real rate of 29.8%, especially long-term certificates of deposit. Current accounts remained stable during the first half of the year, with a variation of 3.24%, while the increase in savings deposits was negative (-6.63%).

Despite deterioration in the loan portfolio quality and arrears indicators, credit institutions enjoyed a relatively constant return on assets during the period in question (2.4%). This was due to broader margin spreads, which originated with a larger rise in the lending rate than in the deposit rate in the financial system.

The loan portfolio of non-bank financial institutions was up by 0.32%, in real terms, during the first half of 2008, when there was a slight shift from foreign assets to certificates of deposit (CDT), bonds and local stocks.

Market risk is at historically low levels, given the sharp drop witnessed since mid-2006 in outstanding TES B held by credit institutions. However, the prices of the assets that comprise the portfolio held by financial institutions grew increasingly volatile during the first half of 2008, and the value at risk - as a percentage of each institution's exposed portfolio - has increased. In this sense, the development of market risk during the remainder of the year is expected to continue at low levels.

Liquidity risk has increased during the course of 2008 due to both local and international factors. As to the local factors, the liquidation of positions in high liquidity assets during the last few years weakens the ability of financial institutions to cope with low-liquidity situations. Internationally, the liquidity squeeze on global financial markets during recent months also could adversely affect liquidity for credit institutions. Due to the increase in reserve requirement during the last few months, reserves are now at higher levels, which is positive in terms of systemic liquidity crises.

Finally, it is important to mention that consolidation of the credit risk management system (SARC), which took effect for the commercial loan portfolio as of the second half of 2007 and as of the second half of 2008 for the consumer loan portfolio, represents significant progress towards a more efficient financial system in terms of risk calculation and management. Preparations to implement the liquidity risk management system (SARL) are crucial at this point in time. SARL defines liquidity risk as "the contingency of failing to comply fully and in due course with the obligation to make payments on time, which is manifest in the lack of liquid assets on hand to do so and / or the need to assume unusual funding costs." Furthermore, it leaves room to consider market liquidity risk by stating "this risk can affect liquidity in the market, which is understood as the ability institutions have to create or dissolve financial positions in a particular market situation."

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