EXECUTIVE SUMMARY

In general, 2006 was a positive year for financial stability, as was the case in recent years. However, deterioration in the quality of consumer loans and the highly concentrated nature of the portfolio held by non-bank financial institutions (NBFI) required an additional effort to arrive at a more rigorous measure of the risks to the financial system. In the case of credit institutions, the year was characterized by two opposite trends. On the one hand, traditional intermediation activities increased dramatically, due to the performance of the Colombian economy. On the other hand, the price volatility of domestic financial assets had a negative impact on investment trading (mostly in domestic government bonds). This led institutions to rearrange the composition of their assets in favor of loans (despite the adjustment in prices on tradable investments during the second half of the year). Consequently, the loan portfolio, as a portion of total assets, rose from 50% in December 2005 to 58% in December 2006, while the proportion corresponding to investments (62% in domestic public debt securities) declined from 32% to 24%.

The shift in the portfolio held by credit institutions contributed to a real annual increase of 26.5% in the gross loan portfolio, mainly because of 42.5% more consumer loans and the recovery in commercial and mortgage lending (22.9% and 6.1%, respectively). The growth in loans was accompanied by good quality indicators for the loan portfolio and high coverage (provisioning/risky portfolio). Nevertheless, quality did suffer between December 2005 and 2006, when the indicator went from 5.7% to 6.7% as a result of 44.5% real average growth in risky consumer loans. Deposit taking from the public rose throughout the year. Coupled with good capital adequacy ratios for the financial system, this appears to suggest little or no restrictions on the supply of credit.

Less income from investment valuation affected the momentum in profits, reducing the return on assets for credit institutions from 2.8% in December 2005 to 2.5% in 2006. However, this is still above average for the last four years.

During the first half of 2006, the price volatility of major tradable assets (i.e. domestic public debt securities and stocks) had a negative impact on the NBFI portfolio. Uncertainty about future prices led to large sell-offs of these assets. The result was a reduction of 1.2% in the value of the portfolio compared to 2005. Although not all NBFI reacted the same way during that period, their focus on domestic instruments meant a generalized adverse effect on their returns.

A healthy increase in loans depends not only on a careful assessment of debtor creditworthiness, but also on whatever risk-management practices are adopted jointly by credit institutions and the National Superintendent of Financial Institutions. Interaction within the scope of good regulations, coupled with careful risk-management by these institutions, will be decisive to the future stability of the financial system. The extent to which the loan portfolio has grown makes it crucial to find ways to measure credit-risk exposure for financial institutions. This is particularly important considering the deterioration we are beginning to see in the quality of consumer loans.

For the most part, credit institutions now are exposed to less market risk. However, the implementation of new regulations in this respect[1] is an important step. It encourages better market-risk measurement and the development of internal models, in addition to prompting other financial institutions to adopt good risk-management practices. This is particularly relevant in the case of NBFI, which continue to have a great deal of exposure given the limited diversification of their portfolios.

Finally, and along the same lines, the adoption of regulations on credit and liquidity risk is extremely important. Exposure to risk of this type will continue to grow if the tendency to substitute tradable investments for loans (i.e. liquid assets) continues. Two regulatory initiatives to this effect are being studied by the National Superintendent of Financial Institutions. One involves anti-cyclical provisioning; the other is the new set of liquidity-risk regulations. Anti-cyclical measures would guarantee enough provisions throughout the credit cycle. This, in turn, would soften the pro-cyclical pattern of the income statement and the supply of credit. The new regulations on liquidity risk would allow elements of market liquidity to be included when calculating exposure. They would also promote more frequent monitoring and a more precise measurement of individual liquidity shortages. The current situation, with good earnings and high levels of capital, is the right time to propose and implement such schemes.

Board of Directors
Banco de la República
Junta Directiva del Banco de la República

[1] New regulations on market risk took effect in January 2007, as stipulated in Chapter 21, External Circular 009/ 2007 issued by the National Superintendent of Financial Institutions in Colombia.

Financial Stability Report

According to its constitutional mandate and Law 31/1992, one of Banco de la República's duties is to ensure price stability. Doing so depends largely on maintaining financial stability. This is achieved when the financial system is able to broker financial flows efficiently. It also helps to improve resource allocation, which is important to preserving macroeconomic stability. Therefore, financial instability has a direct impact on macroeconomic stability and on Banco de la República's capacity to fulfill its constitutional mandate. In short, the need to monitor and maintain financial stability is a crucial one.

Banco de la República performs a variety of tasks to provide for financial stability. First, it must ensure the payment system of the Colombian economy operates properly. Secondly, it extends liquidity to the financial system through its monetary transactions and the exercise of its constitutional faculty as the lender of last resort. Thirdly, being the authority on credit, it also designs financial regulatory mechanisms to reduce episodes of instability. This is done in conjunction with the Office of the National Superintendent of Financial Institutions. Finally, Banco de la República carefully monitors economic trends that might threaten the country's financial stability.

The *Financial Stability Report* is part of this last task and fulfils two objectives. First, it describes the recent performance of the financial system and its principal debtors, so future trends in that performance can be visualized. Secondly, it identifies the major risks to credit institutions. The reason behind both these objectives is to inform the public of the trends and risks that affect the financial system as a whole.

Prepared by
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