Executive Summary

Favorable conditions for increased activity in financial system continued during the first half of 2007. However, during the second quarter, the combined impact of different macroeconomic elements caused that expansion to ease somewhat. The trends in several variables suggest this slowdown will continue, which could spell less relative exposure for financial institutions and the emergence of certain risks. This underscores the necessity of continuously monitoring the more important trends that materialize in this new scenario.

In June, financial institutions registered considerable real growth in the loan portfolio (22.6%). All types of credit contributed to that increase: retail (36.9%), micro-credit (19.9%), commercial loans (17.3%) and mortgages (12.4%, with securitizations). The latter were especially dynamic during the second quarter. Although these growth rates are lofty, they have been falling since early April, when they were the highest of this decade, with the exception of mortgage loans. The slowdown in loan portfolio growth is due to the monetary policy being implemented since April 2006, which included the increase in Banco de la República's intervention rates, the new ordinary and marginal reserve requirements, and the new provisioning system ruled by the National Office of the Superintendent of Financial Institutions.

Despite a considerable build-up in the risky portfolio, above all with respect to retail loans, loan quality remains good. This reiterates the message conveyed in previous editions of the *Financial Stability Report* concerning the importance of monitoring and assessing Retail Loan disbursements. Financial institutions have made an effort to increase provisioning to cover the riskiest portion of their loan portfolios.

The momentum in the loan portfolio during the semester was backed by two complementary trends. First, there was a real increase in deposits with financial institutions (15.1%), which dipped slightly in June. Secondly, financial institutions continued to sell off part of their investment portfolios, as they had been doing since mid-2006. In real terms, investments were down by 19.6% at the end of the first half of the year. Thanks to this tendency, market risk exposure is low compared to past years. This reduction in exposure has been accompanied by new regulations on market risk intended to ensure it is measured properly and adequately covered with capital.

The size of the portfolio held by non-bank financial institutions (NBFI) has grown slowly, and several severance-pay funds have had problems meeting the requirements on minimum profitability. This

underscores the importance of moving forward with the discussion on general rules and regulations for pension fund managers (PFM).

As to the remainder of the year, the economic situation suggests there will be less momentum in financial intermediation activities. The delayed impact of monetary policy on credit activity should continue to materialize in the coming months. Also, from the standpoint of credit demand, agent expectations concerning the state of the economy are more moderate. All of this has occurred in a context marked by interest rate hikes and the rising cost of financial activity, reinforced by the recent tendency among institutions to finance themselves through sources that are more costly but more stable. Certificates of deposit are an example.

A careful analysis of the risks to the banking system is particularly relevant in this situation. As to credit risk, less momentum clearly leads to less relative exposure. Nonetheless, although the risky loan portfolio remains at manageable levels and current loan ratings are not likely to deteriorate, the exercises presented in this report emphasize how vital it is to continue to implement measures that guarantee adequate coverage throughout the economic cycle. The credit risk management system (SARC) ordered by the National Office of the Superintendent of Financial Institutions is a crucial step in that direction.

Several exercises suggest that less liquidity in the local public debt market, due to uncertainty on international capital markets, could affect the liquidity of financial intermediaries. However, the liquidity indicators continue to be favorable. The regulatory steps taken recently by the National Office of the Superintendent of Financial Institutions to improve measurement, monitoring and regulation of this risk are vital.

Finally, the results of the exercises all show how important macroeconomic stability is to minimizing vulnerability in the financial sector to negative changes in conditions on international financial markets.

Board of Directors
Banco de la República