

# Executive Summary

During recent months, the Colombian economy has continued its trend toward sustained recovery. As a result, the main short-term vulnerabilities to the stability of the financial system identified in the September 2017 *Financial Stability Report* have faded gradually. This perception emerges from the analysis of the financial stability risk heatmap presented in Graph A, where the set of relevant macroeconomic variables has gradually abandoned the more intense red shades<sup>1</sup>. Naturally, economic recovery has the effect of reducing the likelihood of further materializations of credit risk in the near future.

In this context, with data to end-2017, credit institutions continued maintaining solid solvency and liquidity indicators despite the reduction in profitability and the slow growth in the volume of credit, which despite its slight recovery has remained in blue shades in the credit cycle region during the past two years (the longest period in such state in the horizon of Graph A).

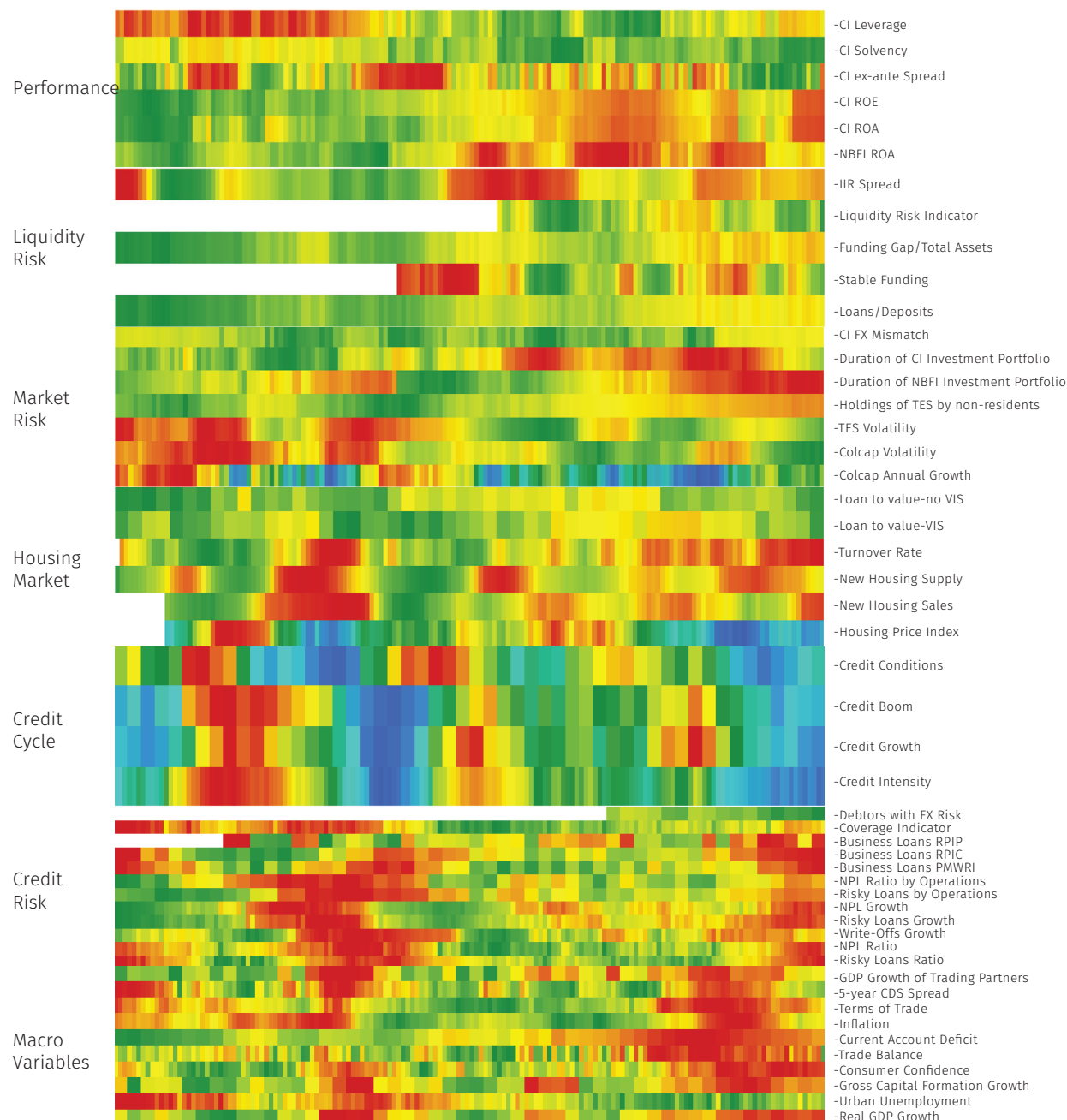
This edition of the *Financial Stability Report* concludes that the main vulnerabilities for the financial stability of the Colombian economy at the moment are associated with: 1) the lagged effect of slow economic growth on the materialization of credit risk in a context of lower profitability of the banking business, and 2) the risk of a return to a path of economic slowdown in the near future. The latter scenario could become plausible in case of a weaker-than-projected economic growth of the country's main trading partners or of a sudden appearance of difficulties in external financing for the Colombian economy.

As in the previous edition of this *Report*, these vulnerabilities could affect the stability of the financial system mainly through the higher costs for credit institutions that would result from the deterioration in the quality of the credit portfolio. In this regard, at the closing of 2017, non-performing loans to the corporate sector and Colombian households still exhibited positive (though declining) growth rates. Specifically, the recent deterioration of the quality of housing loans and of

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<sup>1</sup> The technical details regarding the interpretation, construction, and the variables used in the heatmap are discussed in Box 1 of the September 2017 *Financial Stability Report*.

Graph A  
Risk Heatmap of the Colombian Financial System



Source: Office of the Financial Superintendent of Colombia, DANE, Fedesarrollo, Bloomberg, and Banco de la República; Calculations by Banco de la República.

business loans to firms belonging to the construction sector stands out, which are consistent with the performance of some indicators of the housing market on the heatmap of Graph A.

In order to adopt a prospective approach to these vulnerabilities, Chapter 3 of this *Report* presents a stress test exercise that seeks to assess the resilience of credit institutions in the face of a hypothetical extreme scenario that assumes a deep slowdown of the Colombian economy during the remainder of 2018 and throughout 2019, difficulties regarding external financing, and a greater materialization

of credit risk in vulnerable sectors. Regarding aggregate solvency indicators, the results of this stress test indicate that no significant negative effects would be observed, given that the banking system capital ratio would remain above the regulatory limit during the horizon of the scenario. However, significant negative effects would be observed on the aggregate loan portfolio and on the profitability of the banking business, which reflects the impact of the adverse scenario on the ability of the banking system to create credit and carry out its financial intermediation activities.

Regarding market risk, both the fixed-income and the equity markets have performed well in the recent past, which is reflected in shades of green in the majority of the relevant variables for this category in the risk heatmap. In this case, the vulnerabilities arising from difficulties in external financing could manifest themselves in eventual losses in fixed-income markets. As for funding of credit institutions, their liquidity risk indicator continues to indicate that banks have sufficient levels of liquid resources to meet their short-term obligations, in this occasion with a slight recovery of traditional funding sources. Due to the fact that non-bank financial institutions are mostly exposed to the fixed-income and equity markets, at the closing of 2017 their proprietary trading desks as well as their administered portfolios exhibited a relatively healthy growth accompanied by greater profitability.

The analysis of vulnerabilities presented in this *Report* calls upon participants in the financial markets to ensure that the risks to which they are exposed are being assessed and managed appropriately and prudently. In this context, *Banco de la República*, in compliance with its constitutional objectives, will continue to closely monitor the situation of financial institutions and will make those decisions that will ensure inflation and growth levels that are consistent with macroeconomic stability and long-term economic development.

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