

EXECUTIVE SUMMARY

During the first half of 2009, the world economy continued to experience the effects of the international financial crisis, although some indicators, such as those denoting risk aversion and private sector loan portfolio growth, have improved. In the case of the Colombian economy, the consumer confidence index and the expectation index for industry and commerce demonstrated some recovery, but are still at low levels. More momentum in the economy will have a positive impact on risks to the financial system, the fiscal situation and employment.

The slowdown in the gross loan portfolio held by the Colombian financial system continued in June 2009 (7.3% real annual growth compared to 12.9% the year before), especially consumer lending, which posted -0.5% real annual growth, as opposed to 13.7% a year earlier. On the other hand, the commercial loan portfolio was up 11.4% and mortgage loans, with securitization, registered a real annual increase of 6.6%. Credit institution investment rose considerably, at a real annual rate of 23.8% as opposed to -4.6% in June 2008. This performance explains much of the increase in new holdings of government bonds and their valuation, which occurred in conjunction with the stock market valuations.

The growth in assets (11.3%) was financed largely with deposits, which registered a real annual increase of 14.5% compared to 7.5% the year before. This performance is generalized for all types of deposits. Term certificates of deposit rose at a real annual rate of 19.5%, checking accounts increased 11.6% and savings accounts, 7.7%. The performance of checking and savings accounts was a highlight, considering their growth was near zero in December 2008.

The slowdown in traditional financial intermediation activities was concurrent with a slight deterioration in indicators of default and loan portfolio quality, reflecting further materialization of credit risk. However, credit institutions saw their return on assets (ROA) remain relatively stable at around 2.4%, whereas capital adequacy - measured as the ratio of technical equity to risk-weighted assets, increased 1.1 pp with respect to December 2008, reaching 14.7% in June 2009. Nevertheless, when looking at consolidated capital adequacy; that

is, taking into account the institutions with branches in Colombia and abroad, one sees this indicator is 90 bp lower than the individual indicator, which suggests the system is not quite as sound as expected, but is still above the regulatory minimum of 9%.

Market risk continued to rise as a result of the sharp increase in tradable securities held by credit institutions and their longer duration. Nevertheless, the prices of these securities have become less volatile.

Contrary to the situation in terms of market and credit risk, the first half of 2009 saw less liquidity risk, both in funding and market liquidity, thanks to increased holdings of liquid tradable securities.

Credit institutions have higher capital adequacy ratios than those stipulated by the regulators. The impact of international financial crisis will depend on its duration and depth, and could be less damaging if the external environment shows signs of recovery. The risks to the Colombian financial system during the remainder of the year and in early 2010 will be linked to the performance of the productive sector. Accordingly, it is crucial to continue to monitor those risks closely.

Board of Directors

Banco de la República (Central Bank of Colombia)

FINANCIAL STABILITY REPORT

Prepared by:
The Financial Stability Department of the Monetary and Reserve Division

One of the duties of Banco de la República, as stipulated in the Colombian Constitution and in Law 31/1992, is to ensure price stability. Doing so depends largely on maintaining financial stability, which is understood as a situation in which the financial system is able to broker financial flows effectively. Financial stability contributes to better resource allocation, which is important to preserving macroeconomic stability. For that reason, financial instability has a direct impact on macroeconomic stability and on Banco de la República's capacity to fulfill its constitutional mandate. In short, monitoring and maintaining financial stability are crucial to that activity.

Banco de la República provides for financial stability in a variety of ways. To begin with, it makes sure the payment system in the Colombian economy operates properly. Secondly, it extends liquidity to the financial system through its monetary transactions and by exercising its constitutional faculty as the lender of last resort. Thirdly, being the country's credit authority, it designs financial regulatory mechanisms to reduce episodes of instability. It does so in conjunction with the Office of the Superintendent of Financial Institutions. Moreover, Banco de la República carefully monitors economic trends that could threaten the country's financial stability.

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