

EXECUTIVE SUMMARY

The world economy entered a period of recession during 2008 as a result of the international financial crisis. The outlook for growth in the developed economies during 2009 and 2010 is pessimistic. Fewer exports, fewer remittances and the decline in capital flows to Latin America, including Colombia, will have a negative impact on the productive sector, reflected in low growth rates and higher unemployment. Although the impact of the crisis on Colombia's financial system has been moderate, due to the monetary and exchange measures adopted by the Board of Directors of Banco de la República and owing to the system's limited exposure to toxic assets, the length of the crisis could make intermediaries more vulnerable. However, the country's financial system has shown itself to be sound, particularly the commercial banks. This will help to cushion the negative effects of additional credit risk.

The slowdown in the growth of financial brokerage activities, evident since 2007, was more pronounced during the second half of 2008. By December 2008, the real annual increase in assets in the financial system was 8.2%, compared to 12.5% the year before. This loss of momentum is explained by a smaller growth in the total gross portfolio, which came to 9.4% (20.3% at December 2007). The same was true of the different types of loans. By the end of 2008, the real annual increase in the commercial, consumption and mortgage loan portfolios was 12.9%, 4.1% and 6.1%, respectively, as opposed to 16.3%, 28.1% and 12.8% the year before. The slowdown in total loan portfolio growth was more pronounced for commercial financing companies (CFC) and registered a real annual increase of 2.3% at the close of 2008.

The reduction in loan portfolio growth was accompanied by deterioration in quality and non-performance indicators. As a percentage of the total portfolio, the portfolio at risk (non-A-rated loans) was 8.9% by December 2008. This is 2.3 percentage points more than a year earlier. The quality indicators for commercial and consumption loans exhibited similar, although more pronounced, behavior (11.7% and 7.6%, respectively). This increase in the portfolio at risk applies to loans granted during the second half of 2008; at the start, their portfolio quality indicators are more unfavorable than those of

loans granted during previous half-year periods. Moreover, all the portfolios analyzed showed an increase in the probability of migration from less risky ratings (A and B) to those that imply more risk (C, D and E). This could raise the loan portfolio default index during 2009.

On the other hand, the increase in deposits, which were up by a real annual rate of 9.6%, is consistent with the current dynamics of assets in the system. Basically, this is explained by the increase in term deposits (CDT in Spanish), with 26.4% real annual growth by December (25.5% a year earlier), while savings and checking accounts increased at respective rates of 0.3% and 0.4%, compared to 5.4% and 5.0% a year earlier.

Although assets in the financial system saw less of an increase during 2008 than in previous years, the return on assets (ROA) has remained stable (2.46% at December 2008, which is similar to the average since 2006). Nevertheless, this indicator could deteriorate if the non-performing loans continue to grow.

Government bond holdings have increased since November, raising the system's market risk and lowering its liquidity risk. In a context of lower inflation expectations and added levels of credit risk, there are incentives for institutions in the financial system to continue to increase the share of their assets comprised of securities.

The credit institutions have capital adequacy ratios above the mandatory levels, but they could deteriorate in a less favorable scenario. Therefore, continued and careful monitoring of the risks to the financial system is particularly important, as is the implementation of counter-cyclical policies, which are essential to safeguarding the health of credit institutions.

Board of Directors
Banco de la República

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 where the financial system is able to broker financial flows efficiently. 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 the Central Bank'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. First of all, 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 Superintendencia Financiera de Colombia. Furthermore, the Central Bank 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 affect the financial system as a whole.