

EXECUTIVE SUMMARY

During the second half of 2009, the world economy showed signs of recovery from the international financial crisis, reflected in lower level of risk aversion. However, fiscal pressures are mounting on developed economies due to increased government spending generated by the stimulus measures and could undermine the momentum in the global economy. In the case of Colombia, the indexes of consumer confidence and expectations for industry and commerce have recovered, but are still at levels below those registered prior to the financial crisis. The letter could result in a more optimistic scenario for increased intermediation activity in the financial system.

Financial system assets grew less during the second half of 2009; the annual increase went from 11.3% in June to 6.7% by the end of the year. This is largely the result of less growth in the total loan portfolio, which accounts for 64.4% of assets. Specifically, the different types of consumer and commercial lending posted negative annual real growth rates in December 2009: -0.4% and -1.6%, respectively. In contrast, the rate of growth in investments by credit institutions went from 23.8% in June 2009 to 28.4% six months later. Consequently, investments as a share of total assets rose 1.6 percentage points (pp) and came to 21.6% by December 2009.

Annual real growth in deposits declined from 14.5% in June 2009 to 5.8% by the end of the year. As for the different types of deposits, the annual real increase in CDs declined from 19.5% in June to -2.9% six months later. Current and savings accounts were up 6.2% and 10.1%, respectively, by the end of the year. This performance reflects a shift in deposits towards sight accounts, owing to lower interest rates and less inflation.

As for credit risk, the risky portfolio indicators for all types of loans other than commercial lending improved during the second half of 2009. Accordingly, the risky portfolio (non-A rated loans), as a percentage of the total portfolio, remained relatively stable and was 9.7% in December 2009. The same indicator for the commercial loan portfolio increased from 7.9% in June 2009 to 9.5% six months later; however, this is not a record high. Therefore, lending of this type must continue to be monitored closely. The non-performing portfolio as a

proportion of the gross loan portfolio declined for all types of lending, having gone from 5.3% in June 2009 to 4.6% by the end of the year.

Contrary to what occurred with credit risk, the increase in government bond holdings, particularly concerning the share of marketable securities, coupled with the added volatility in TES returns, has heightened exposure to market risk. Accordingly, it is important to keep a close eye on how this risk affects the performance of financial institutions. It also is important to bear in mind that the increase in government bond holdings lowered the exposure to liquidity risk.

Finally, in spite of the international financial crisis, there have been major changes in the profitability and capital adequacy indicators for the Colombian financial system. Interest income still accounts for the bulk of all financial income and, despite a lower spread, the return on assets remained relatively constant at 2.4% during the second half of 2009. This was due, in part, to the increase in earnings from investment valuation. The capital adequacy ratio increased 30 basis points (bp) to 14.9% by the end of last year.

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 Superintendencia Financiera de Colombia. (Financial Superintendence) 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.