

SUMARY AND CONCLUSIONS

✕ One of the main functions of the Central Bank is to ensure that the economy's payment system operates on a firm and efficient basis. The stability of the financial system is essential to this task. For this reason, the first edition of the Financial Stability Report was published by Banco de la República in July 2002.

✕ This is the second edition of the report. Like the first, it continues to present the Bank's view of how the financial system has evolved and the nighights most important developments in recent months.

✕ Several of the trends mentioned in the last report became more pronounced in 2002, in particular the recovery in profitability of the financial system and the consolidation of the trend towards an improvement in the quality of its holdings.

✕ The July report summarized a tendency to reassign assets within the balance sheet of financial institutions, characterized by a sharp decline in the share of credit within the banking industry. This trend began to reverse itself in recent months, particularly for certain agents in the financial system.

✕ As indicated herein, the balance sheets of the financial system and those of its private clients have improved, although slowly. However, both sectors remain exposed to shocks posed by macroeconomic variables.

✕ Within this framework, the current edition of the Financial Stability Report outlines the principal trends in the economy to analyze the aggregate debt in the non-financial sector, recent performance of the system's major debtors, and performance of the financial system itself.

RECENT PERFORMANCE OF LEADING DEBTORS AND THE RISKS TO THE FINANCIAL SYSTEM DERIVED FROM EXPOSURE TO THEM

Corporate Sector

✕ Exposure of the financial system to the private corporate sector increased slightly during the first six months of 2002, following a persistent decline between 1998 and 2001. This increase was due primarily to the trend in the commercial lean portfolio.

✘ The risk posed to the financial system by the major sectors of the economy continued to abate, insofar as the quality of the portfolio has improved. Although indexes for the building sector remained unfavorable, the quality of its loan portfolio has improved steadily. If the sector maintains its momentum, this trend will likely continue, thereby reducing the risk to the financial system.

✘ A limited group of companies regulated by the Securities Commission (Supervalores) was analyzed in the July report and several indicators of their ability to pay were shown to have experienced some improvement in 2001. The present report focuses on a larger group of companies including of those regulated by Supervalores and by the Corporate Commission (Supersociedades). An analysis of this larger sample confirmed the conclusion that ability to pay had improved during 2001.

✘ The third quarter of 2002 saw a substantial decline in the financial indicators of companies regulated by Supervalores. Although this was a general trend, it was more pronounced among companies producing non-tradables, due to real the devaluation of the exchange rate.

✘ The positive way certain indicators for the tradable sector responded to devaluation before 2001 and the negative response of non-tradable companies to devaluation up to the third quarter of 2002 indicate the financial stability of the corporate sector is extremely sensitive to sharp fluctuations in the exchange rate. This being the case, extreme instability in this variable poses risks for important lines in the productive sector of the economy.

✘ The limited force of internal and external demand, especially at the start of 2002, is reflected in the standstill in business operational income. In this context, an additional slump in demand is the second most important risk to financial stability of the productive sector.

✘ According to different surveys on aggregate growth of the economy, business opinion remains highly conservative. Most of those surveyed have no immediate plans to increase their personnel. In an indirect way, this indicates they have no ambitious investment plans for the near future. The indicators seem to denote the possibility of a moderate increase in demand in the short term similar to the one observed in recent months.

Households

✘ The first six months of 2002 were characterized by a steady decline in the financial system's exposure to the household sector. This trend began in 1998 and has placed household debt exposure at its lowest level since 1996. However, although the decline in the household debt portfolio applied to mortgage banks (BECHS), as well as to commercial finance companies (CFC) and commercial banks, the dynamics of the last two are different and were responsible for reversing their trend as of May 2002.

✘ During the course of 2002 to date, the household portfolio has improved slightly compared with the previous year. This is reflected in an increase in the share of class-A holdings. The improvement coincides with less of a decline in the price of assets and more income for wage earners compared with the year before, suggesting this sector of the population has a better ability

to pay. Nonetheless, because of the trend in employment and unemployment rates, the same cannot be said for the household sector in its entirety.

✕ As to household borrowing in the future, different surveys give mixed signals about the trend in demand for credit. Some indicators show a decline in the number of households that believe this is the time to acquire goods and property. However, the consumer confidence and economic indexes are relatively high compared with last year. The latest information from these surveys (not included herein) ratifies this trend. Consequently, if growth in consumer credit continues and mortgage portfolio placement keeps improving, there could be a moderate increase in household demand for credit.

Non-financial Public Sector

✕ Growth in the financial system's exposure to the public sector in recent years slowed during the first six months of 2002 and became even more moderate in the second half of the year, with the purchase of government bonds by Banco de la República.

✕ In the years prior to 2002, the non-financial public sector (NFPS), particularly the central government, saw its debt increase steadily and its financial indicators decline. As mentioned in the last report, with government bonds accounting for a larger portion of the system's assets, deterioration in the public sector's financial position posed a risk to the financial sector. This risk materialized in July and August when interest rates on these securities rose by nearly 200 basis points (bp), generating losses in the value of paper held by the system

✕ Because this effect was not enough to induce losses in the overall balance of the system, the conclusion is that, with current exposure, intermediaries can absorb a shock of this proportion without having their stability threatened. The months after August saw an improvement in the terms of the debt, which led to profits for the financial system.

✕ However, the public sector's financial position clearly remains an important factor in the solvency of the financial sector. For this reason, the necessary adjustments are a priority if sustainability of the public debt is to be guaranteed.

✕ The July edition of the Financial Stability Report mentioned the importance of the system's exposure to the debt of territorial agencies, not only because of the amount but also because of its poor quality. This exposure has declined in recent months, in real terms, and the quality of the portfolio has improved, thereby reducing the risk these agents pose to the stability of the financial system.

RECENT DEVELOPMENTS IN THE FINANCIAL SYSTEM

✕ The profitability of the financial system improved during the course of the year. The increased profitability of the portfolio business and other commission-earning activities played an important role in this respect.

✘ The quality of the sector's assets has also gotten better. Nevertheless, asset performance remains asymmetric, depending on the type of holding. While there has been a substantial and sustained improvement in the commercial and consumer portfolios, mortgage portfolio performance continues to imply considerable risk.

✘ As a result of this trend, the system's dead assets are concentrated in the mortgage sector (BECH). These banks are the intermediaries with the largest share of mortgage holdings on their balance sheets.

✘ In addition to credit risk, mortgage banks also face considerable risk from interest rates. However, there were two securitization operations during the course of the year, which means mechanisms are being developed to reduce this risk in the mid-term.

✘ A systematic tendency towards portfolio replacement with investments was summarized in the last report and continued until May 2002. However, in recent months, the portion of total assets corresponding to credit has grown considerably, in detriment of the investment share. This tendency increased in the final months of 2002 with sales of government bonds to the Banco de la República by financial institutions.

✘ In spite of portfolio performance in recent months, the financial sector's tendency to assume new risks was reinforced throughout 2002, especially those associated with futures and derivatives, as well as treasury operations.

✘ This underscores the importance of implementing capital requirements and having the capacity to regulate these new activities, which do not necessarily require the movement of resources from one financial institution to another.

RISKS DERIVED FROM THE MACROECONOMIC SITUATION

✘ Four sources of potential risk derived from macroeconomic performance were suggested in the last report; namely, changes in capital flows, the trend in absorption, problems with public financing, and external demand.

✘ Capital flows to emerging countries slowed in 2002 and Colombia was no exception. Macroeconomic projections for 2003 indicate this trend could continue to have a negative impact on interest rates, expectations of devaluation and the exchange rate. The financial system could be affected as a result.

✘ There have been no major changes in the momentum of absorption, which has grown increasingly in recent months. This trend is expected to continue.

✘ The economic situation confronting Colombia's trading partners spells low external demand for domestic goods. This has an impact on companies producing tradables. Through them, lenders in the financial system are affected as well. High devaluation in the second half of 2002 is expected to mean more operational income for these companies in 2003.

✚ As mentioned earlier, the behavior of fiscal variables has considerable bearing on the financial system. Therefore, the stability of the system is linked to what happens on this front.

Board of Directors
Banco de la República