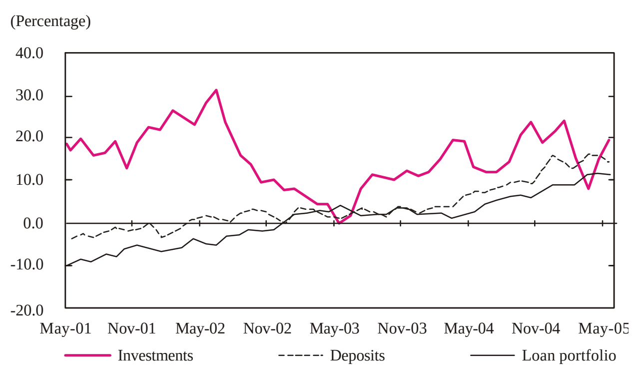
Executive Summary

Favorable external and internal conditions have made possible the continued solid expansion of the Colombian Financial System during the first months of 2005. Evidence of this is the accelerated growth of deposits, gross loans and investments held by the banking and non-banking financial institutions.

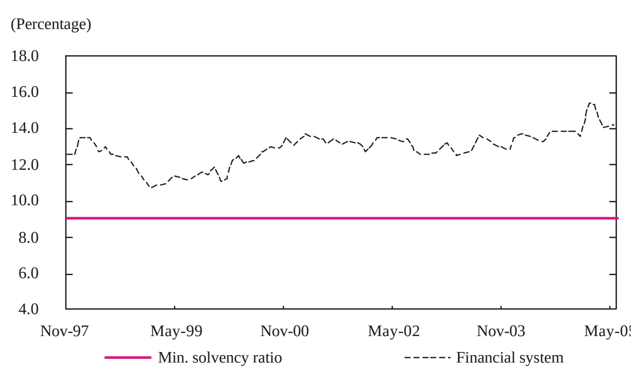
Real annual growth of the main balance sheet accounts



Source: Banking Superintendency, Banco de la República calculations

Financial margins have increased as a result of deposit recomposition toward less expensive funding sources and because of a major expansion of loans with higher interest rates (consumer). The enhanced financial intermediation and the decrease in non-performing loan levels also speak well of the financial system's profitability. This has notably strengthened the capital gearing of banking institutions, placing capital adequacy ratios at historically high levels.

Solvency ratio

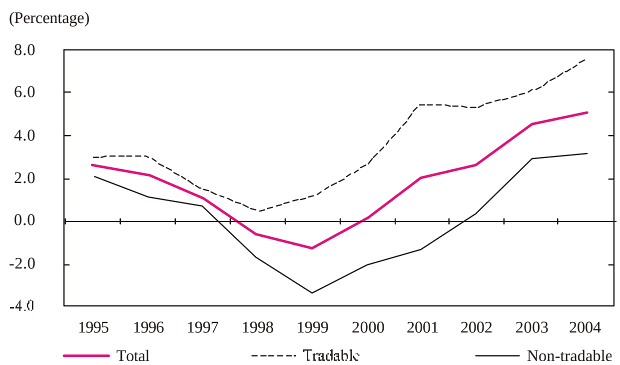


Source: Banking Superintendency, Banco de la República calculations.

The financial system's low level of non-performing loans is the effect of systematic improvements in the financial situation of the system's private debtors. As far as the private non-financial corporate sector is concerned, there has also been a surge in sales which coupled with lower operating costs, have meant notable increases in profitability and capital strength. With respect to external liabilities, businesses continue to rely on domestic funding rather than external financing sources. Overall, this has implied a lesser financial burden and hence lower vulnerability.

In the case of households, financial conditions have improved, mainly due to higher employment rates and because of the real growth of wages within industry and trade. This is the main reason for the credit growth granted to households, particularly consumer credit.

PROFITABILITY INDICATOR



Source: Corporations and Securities Superintendency and Banco de la República.

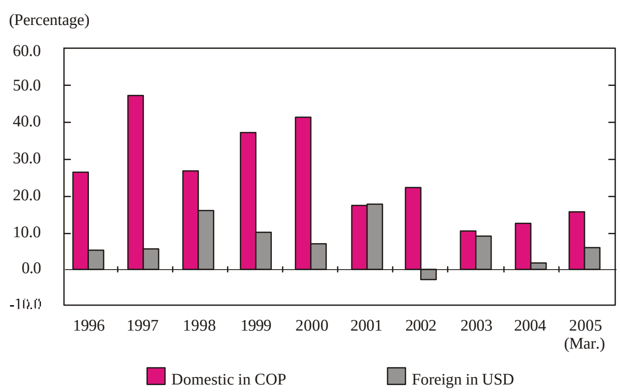
With regard to the future, agents' outlook continues to be maintained towards a positive perspective. In effect, entrepreneurs are optimistic about the growth of the economy, the improvement of business conditions, the availability of credit, and the development of new investment projects. Households themselves believe that their economic situation will improve further and that it is a good time to acquire durable goods. These results show that the demand for credit could very well continue expanding in the months to come.

The private sectors' good situation and the better provisioning for non-performing loans by the banks suggest that credit risk does not represent a significant problem to financial stability in the short run.

The main risk to the aforesaid stability lies on the public debt front, although the recent pension reform and the lower interest-rate levels have helped to reduce it. The Government's indebtedness process has involved replacing external for internal debt and increasing the greater participation of investments on financial institutions' balance sheets, which has entailed a higher exposure of public debt to market risk.

As a result of the increased exposure, the balance sheets of institutions are more sensitive to changes in investment value. Thus, progress on regulations governing the measurement and monitoring of such changes should continue so as to improve market risk management. In this connection, a workgroup has been set up by the Banking Superintendency and the *Banco de la República* to work on these topics.

ANNUAL NOMINAL GROWTH OF THE NFPS DEBT



Source: Banco de la República.

To sum up, the financial system enjoys conditions that favor stability and growth. Both the external and internal macroeconomic aspects have been positive and debtors have improved their capital structure position, which has meant lower credit risk. However, the greater participation of investments within institutional assets has increased their exposure to market risk and so there is a need to focus on topics addressing this particular risk.

The Board of Governors of the *Banco de la República*