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The Colombian financial system has not suffered major structural disruptions during these months of deep economic contraction and has continued to carry out its basic functions as usual, thus facilitating the economy's response to extreme conditions. This is the result of the soundness of financial institutions at the beginning of the crisis, which was reflected in high liquidity and capital adequacy indicators as well as in the timely response of various authorities. *Banco de la República* lowered its policy interest rates 250 points to 1.75%, the lowest level since the creation of the new independent bank in 1991, and provided ample temporary and permanent liquidity in both pesos and foreign currency. The Office of the Financial Superintendent of Colombia, in turn, adopted prudential measures to facilitate changes in the conditions for loans in effect and temporary rules for rating and loan-loss provisions. Finally, the national government expanded the transfers as well as the guaranteed credit programs for the economy.

The supply of real credit (i.e. discounting inflation) in the economy is 4% higher today than it was 12 months ago with especially marked growth in the housing (5.6%) and commercial (4.7%) loan portfolios (2.3% in consumer and -0.1% in microloans), but there have been significant changes over time. During the first few months of the quarantine, firms increased their demands for liquidity sharply while consumers reduced theirs. Since then, the growth of credit to firms has tended to slow down, while consumer and housing credit has grown. The financial system has responded satisfactorily to the changes in the respective demands of each group or sector and loans may grow at high rates in 2021 if GDP grows at rates close to 4.6% as the technical staff at the Bank expects; but the forecasts are highly uncertain.

After the strict quarantine implemented by authorities in Colombia, the turmoil seen in March and early April, which was evident in the sudden reddening of macroeconomic variables on the risk heatmap in Graph A,[1] and the drop in crude oil and coal prices (note the high volatility registered in market risk for the region on Graph A) the local financial markets stabilized relatively quickly. *Banco de la República*'s credible and sustained policy response played a decisive role in this stabilization in terms of liquidity provision through a sharp expansion of repo operations (and changes in amounts, terms, counterparties, and eligible instruments), the purchases of public and private debt, and the reduction in bank reserve requirements. In this respect, there is now abundant aggregate liquidity and significant improvements in the liquidity position of investment funds.

In this context, the main vulnerability factor for financial stability in the short term is still the high degree of uncertainty surrounding loan quality. First, the future trajectory of the number of people infected and deceased by the virus and the possible need for additional health measures is uncertain. For that reason, there is also uncertainty about the path for economic recovery in the short and medium term. Second, the degree to which the current shock will be reflected in loan quality once the risk materializes in banks' financial statements is uncertain. For the time being, the credit risk heatmap (Graph B) indicates that non-performing and risky loans have not shown major deterioration, but past experience indicates that periods of sharp economic slowdown eventually tend to coincide with rises in non-performing loans: the calculations included in this report suggest that the impact of the recession on credit quality could be significant in the short term. This is particularly worrying since the profitability of credit establishments has been declining in recent months, and this could affect their ability to provide credit to the real sector of the economy.

In order to adopt a forward-looking approach to this vulnerability, this Report presents several stress tests that evaluate the resilience of the liquidity and capital adequacy of credit institutions and investment funds in the event of a hypothetical scenario that seeks to simulate an extreme version of current macroeconomic conditions. The results suggest that even though there could be strong impacts on the credit institutions' volume of credit and profitability under such scenarios, aggregate indicators of total and core capital adequacy will probably remain at levels that are above the regulatory limits over the horizon of a year. At the same time, the exercises highlight the high capacity of the system's liquidity to face adverse scenarios.

In compliance with its constitutional objectives and in coordination with the financial system's security network, *Banco de la República* will continue to closely monitor the outlook for financial stability at this juncture and will make the decisions that are necessary to ensure the proper functioning of the economy, facilitate the flow of sufficient credit and liquidity resources, and further the smooth operation of the payment systems.

Juan José Echavarría
Governor