Let's **Make Progress**

Chapter 2

Our Operational Environment

145 Years Making Progress

We believe in the value of being close to our clients, assisting them with financial services wherever they are, thanks to our presence in 12 countries in the region.

2. Our Operational Environment

International Context

Two processes stood out in the semester in the international context. The first revolved around the slowdown in the economic activity of the United States during the first quarter and its later recovery. The second was of political nature and was associated with the victory of the left-wing Syriza party in the Greek parliamentary elections. On repeated occasions, the central scenario of the analysts was the breakdown of the European monetary union due to the possible Greek exit.

Similar to what occurred a year ago, the growth of the first quarter in the United States was particularly weak. As the Federal Reserve will recognize this fact later on, the lower rate of growth was due to temporary factors such as the strike in ports of the Pacific coast and winter's effect on some regions of the country. However, the upwards reviews at the first quarter and the positive surprises in growth in the second quarter allow an expansion process to be seen in accordance with the economy's potential growth. Due to the above, the global strength of the dollar and the expectation of an increase in the interest rates in 2015 were consolidated. In the future, with the appearance of global risks, such as the slower rate of growth led by China, the possibility of a change in monetary policy until 2016 is not ruled out.

Again, U.S. labor indicators continue to be the main argument for the Federal Reserve to increase the interest rate before the end of 2015. Unemployment continues its unmistakable downward trend and in August, it reached 5.1%, the lowest level since 2008. Employment generation also maintained a positive trend, although with ups and downs and recurrent negative surprises. Taking the Federal Reserve's full employment rate of 5.1% as a reference, the proximity to compliance with one of the elements of the constitutional mandate is remarkable. However, the Federal Reserve is awaiting an additional improvement, which is increasingly lower according to communications of the labor market meetings.

The second major issue of the year so far had both political and economic components. The Syriza political party coming into power in Greece from a platform against austerity and insufficient public resources made visible the difficulties of this country's negotiation process with the creditors of the prior bailout programs. On multiple occasions where the capital adequacy and liquidity of the Greek government was questioned, it was never possible to rule out the breakdown of the European monetary union.

Two critical situations were the calling of a referendum on the measures that were discussed with the creditors (end of June) and the discussion in the European institutions about the design of the third aid program (middle of June). Both situations presented measures for a real crisis, including: capital controls, mass reduction of bank deposits, non-payment of international institutions and speculation about the reintroduction of the drachma, among others. In light of a possible breakdown of the European monetary union, the Euro devalued before its main commercial partners, at the same time that aversion to the global risk appeared repeatedly. In this context, the implementation of the asset purchase program by the European Central Bank occupied a secondary role.

Finally, global inflation remained at low levels that had the international financial crisis as a closer reference. Deflation was a concern again, especially in the Eurozone. Similar to 2014, low oil prices were the main determining factor, and together with the slowdown of economic activity, this generated a global expansive monetary policy. From China to Canada, passing through Europe, and with less strength in Latin America, central banks reduced their interest rates to combat the low inflation.

U.S. labor indicators continue to be the main argument for the Federal Reserve to increase the interest rate before the end of 2015.

Colombia

In the first semester of 2015, the Colombian economy had an annual growth of 2.9%, compared to 5.3% from the previous year. In this way, in the last 12 months, growth has distanced itself from potentially accumulating a variation of 3.3%. In the first part of the year, all of the sectors, except mining (2.4% vs. 1.9%), recorded a significant slowdown. Despite the reduction, construction (6.7%), commerce (4.4%) and the financial services sector (3.9%) grew above the aggregate of the economy. Meanwhile, industry lagged behind, decreasing -1.8% in the year so far, while other sectors such as social services (2.7%) and transport (1.7%) presented lower growth than the economy as a whole.

The most recent data confirms that economic growth continues at a moderate pace in the third quarter. In July, retail sales recorded an annual expansion of 4.5% compared to 5.2% the year before, and industrial production continued to decrease YoY at 0.2% compared to 1.8% in July 2014. Additionally, consumer trust, which maintained a downward trend in the first semester, went into negative figures in August (0.4 points), a situation that had not occurred since 2009. Consequently, the slowdown of domestic consumption continued in the second half of the year.

The risks that affect activity continue to be latent with the drop in the price of oil and its consequences for economic investment and government expenditure, in particular. Precisely the growth forecasts have continued to be reviewed in a downward trend, being one of the most notorious cases in the Central Bank of Colombia, which now estimates a 2.8% growth of the GDP for 2015. Our Economic Research Management forecasts a growth of 3.0%.

Alongside prices, inflation has remained high in the year up to August at an average of 4.4%, above the target range established by the Central Bank of Colombia (2.0% - 4.0%). Basic inflation measurements, which usually exclude volatile components or are out of reach of monetary policy also, increased and were even above the upper limit of the target range (4.2% without food and 4.5% without food and regulated items).

Initially, the rise in prices was driven by a supply shock in food, but over time and with the correction of said effect, other upward sources arose. In particular, the strong devaluation of the Colombian peso stood out, which has tripled inflation of tradable goods in the last year (from 1.6% to 5.2%), and it has become the main risk for total inflation in recent months. Two other risks that have gained importance are: the impact that El Niño phenomenon will have on food prices and the effect of indexation or dependency on past prices. Our Economic Research

Office forecasts that inflation will remain high for the rest of the year, ending at 4.7% above the target.

In this context, inflation expectations resulting from the quoting of government securities on the market (TES), or implicit inflation, exceeded the upper limit of the Central Bank's target range and suggested the start of a short-term contractionary monetary policy.

With a slowdown in the economy and elevated inflation, the quandary of monetary policy was exacerbated to the point that in the July and August Board meetings of the Central Bank of Colombia, the unanimous vote to maintain the interest rate benchmark stable (4.50%) was broken, with some members opting for an increase. The divergence of opinions within the entity was unexpected and led to the market disregarding the possibility of increases in the interest rate, when cuts had been forecast in previous months. Therefore, with upward risks of inflation that did not appear to be compensated by the slowdown of internal demand, we consider it likely that the Central Bank of Colombia will increase the interest rate before the end of the year. In turn, the average FTD (Fixed Term Deposit) rate for August was 4.47%.

Another point in favor of an increase in rates results from the external imbalances of the economy, which also became one of its main vulnerabilities. With an internal demand that grew above the economy for several years, the need for checking account financing was covered with foreign direct investment, mainly the oil and mining sector. However, with the drop in the price of oil, exports were reduced, expanding the lack of commercial balance, and foreign direct investment also reduced. During the year until June, exports dropped 31% to USD 19,300 million, while foreign direct investment reduced 23% to USD 8,200 million in the year up to August, according to the exchange balance. Additionally, portfolio foreign investment dropped 60% to USD 3,600 million.

Although imports have also started to adjust as a result of the reduced growth, primarily due to the increase in prices of purchases abroad (because of the higher exchange rate), the adjustment has been insufficient. In the year up to June, imports dropped 11% to USD 26,000 million (FOB), leaving a commercial deficit of USD 6,700 million, above the recorded amount for 2014 (-USD 6,300 million).

In light of this discrepancy, the flexible exchange rate continues to have a stabilizing role. For this reason, the Central Bank of Colombia did not intervene the foreign exchange market margin, differentiating it from the majority of Latin America's central banks. However, if one of the following conditions is met, it is possible that the entity will intervene in the market with the sale of international reserves: 1) Greater transmission of devaluation to inflation and unraveling of financial expectations; 2) Risks in the financial assets markets; and 3) Risks in the financial system.

In the first semester, the average exchange rate was COP 2,483, but in July and August, the unease in international markets about possible changes in the Federal Reserve's monetary policy, the lower oil prices and concerns about financing the country's external accounts led to a historical change of the exchange rate, above COP 3,200. At the end of August, the foreign exchange rate was COP 3,079.97.

The external imbalance became the main vulnerability of the Colombian economy and the devaluation of the exchange rate became an upward risk for inflation.

Colombian Banking System

The year 2015 started with the implementation of international reporting standards of accounts under the parameters of the International Financial Reporting Standards (IFRS), with the aim to standardize financial language between countries. Within the framework of Law 1314 / 2009, issued by the Colombian Congress, the application of this new methodology was made official, facilitating the access of the banking sector and companies of the non-financial sector to capital markets and comparative positioning in the world.

Additionally, in light of the forecast slowdown of the Colombian economy and the volatility of international financial markets, local banking reflected a solid equity and financial structure that manages adequate liquidity indicators and make it resistant to the fluctuations of the national and international economic cycle.

In this way, the banking system increased its assets by 15.4%, amounting to COP 470.0 trillion at June 2015, principally driven by the growth of gross loans and financial leases, which had an annual variation of 16.2%, ending the first semester with COP 328.4 trillion. In particular, consumer and commercial loans had the highest growth of 14.3% and 12.0%, respectively. The quality and coverage indicators were at adequate levels as well: 3.0% and 144.6%, respectively.

Certificates of deposit (CDs) were the deposit products that grew the most in 2015 (23.3%), ending the semester with a value of COP 98.2 trillion. However, savings accounts continue to hold the highest share of the deposits category, COP 144.1 trillion (48.2% of the total). The banking system's profit was COP 5.1 trillion.

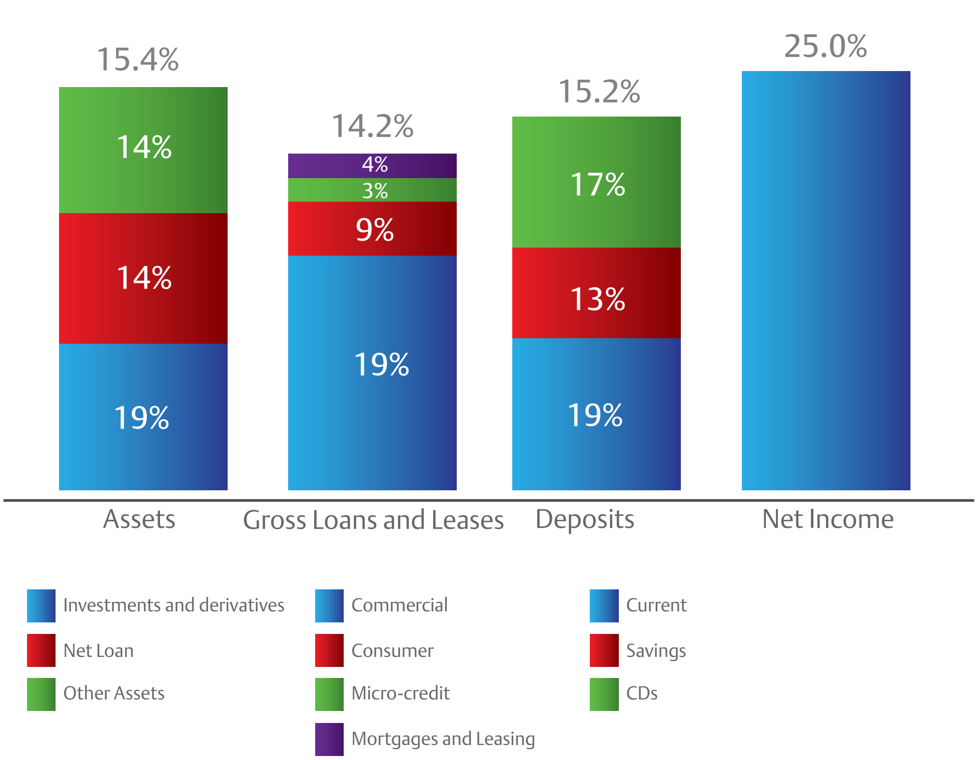
The achievements of the Colombian banking system include advances in coverage (presence in almost all of the Colombian municipalities), increasing use of alternative channels such as Internet and mobile banking, elevated levels of innovation and development, and extension of the financial education programs, reflecting its commitment to the challenges the country faces regarding the incorporation into the banking system.

Our Share in the Colombian Banking System

At June 2015, the Bank held a 15.4% share of assets, 19.4% of investments and derivative transactions, 14.2% of the gross loans and leases, 19.0% of commercial loans and leases, 9.4% of consumer loans and leases, 4.2% of mortgage loans and leases, 19.2% of checking account deposits, 13.3% of savings account deposits, 17.1% of CDs, 22.1% of equity and 25.0% of net income.

Colombian Market Share

(Market Share Figures as of June 2015)



Giovanni Muñoz Chávez
Avanza - National Savings and Loan Cooperative - Manager
Social Banking Client

Avanza Cooperative

Cutting-edge Social Banking

While the digital turn indicator reports it is time to receive service, two enormous screens announce the broad offer the cooperative has scheduled for the upcoming months to more than 10,000 associates of Avanza. It is easy to recognize the excitement that some announcements generate, such as the start of cooking courses, the academic excellence scholarship, agreements with the region's theme parks, and especially the upcoming opening of the renovated Sede Social Finca Hotel San José.

It is a tourist complex in the beautiful landscape of the coffee region, which will have 32 rooms, 4 swimming pools, 2 auditoriums and a traditional restaurant, providing associates with the opportunity to rest and spend time together with their families. "I found an ally in Banco de Bogotá to multiply social wellbeing in the region. We obtained important resources with very favorable conditions," states Giovanni Muñoz Chávez, Avanza Manager.

However, the creation of the relationship between the entities had a more structural background. In 1980, 27 employees of the Branch Office of the Quindío Health Service created the cooperative with the mission to offer the best savings and loans services to its associates, generating corporate social responsibility actions that would benefit the community. They rapidly extended the cooperative's services to employees of the department's public hospitals and later to other sectors.

Eighteen years ago, Avanza put the Affinity Debit Card at the service of its members, facilitating access to our network of ATMs and partner commercial establishments.

With a growing base of people registered, they needed to build a strong relationship with a partner in the financial sector that specialized in and understood the social banking context. Therefore, 18 years ago, they consolidated the agreement to be innovative in the range of services for the cooperative sector, being the first to implement the "Affinity" debit card. "What we really wanted is to provide a good service to our associates, and to this end, we needed to be up to date in technology. For this to be possible, we have had the constant support of Banco de Bogotá, which in turn, has extended its portfolio to the cooperative for it to be offered to its associates."

Avanza is now one of the main players of the country's solidarity sector, with a base of 300 affiliated entities (which include 40 social and cooperative sector organizations) as employee funds and associations, five agencies in the departments of Quindío, Norte del Valle, Risaralda and Caquetá, and more than 20,000 beneficiaries.