

Box 4 The Role of the Supervisor in the Reversal of the Recent Deterioration in the Loan Portfolio

Office of the Financial Superintendent of Colombia (SFC)*

In 2017 the SFC introduced two monitoring strategies and a regulatory initiative in order to reverse the upward trend of the non-performing loan portfolio, which had become more accentuated since the end of 2016, and to reinforce a proper disclosure of credit risk. This box presents the rationale behind these strategies and evaluates their effectiveness based on the available evidence. The last section describes the supervisory approach with regard to credit risk that is being developed in 2019.

1. The Context of the Measures

Historically, the non-performing loan portfolio responded both directly and lagged behind the growth of the gross loan portfolio.¹ Nevertheless, since the end of 2015, there has been a breakdown in this relationship and, contrary to what was expected, the downturn in the gross portfolio did not translate into a comparable decrease in the deterioration (Graph B4.1).

The disconnection, which still persists, was attributed to the effect of the supply shock experienced in 2014 and the drop in crude oil prices together with the idiosyncratic deterioration of some debtors who were heavily exposed.² In addition to this disparity between the growth rates of gross and non-performing loan portfolios, the latter departed from its long-term growth trajectory (shaded area³ in Graph B4.2),

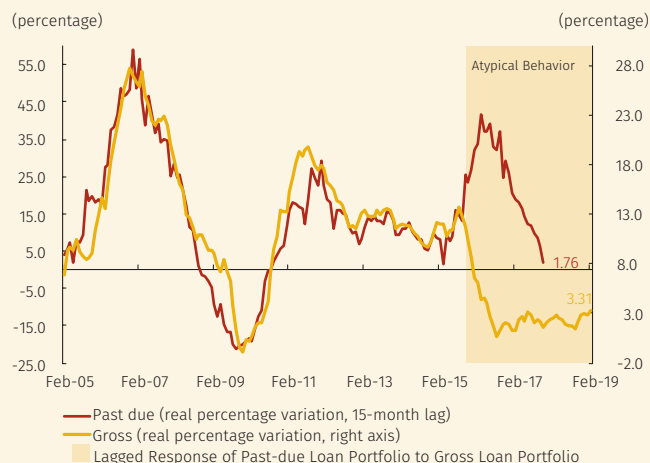
* The opinions presented herein do not compromise Banco de la República nor its Board of Directors.

1 FSC (2011) Notes from the Supervisor No. 001. *The growth of credit and its impact on the non-performing loan portfolio: a direct and lagged relationship.*

2 *Electricaribe and Ruta del Sol II.*

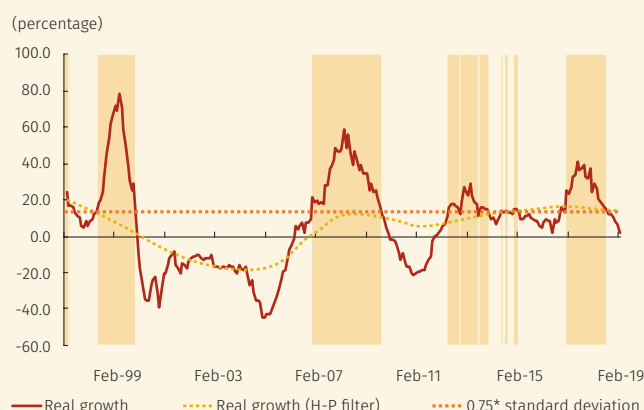
3 The activation threshold for deviation with respect to the trend (shaded area) combines three simultaneous events: positive growth of the past-

Graph B4.1
Relation of Past-due Portfolio and Gross Loan Portfolio



Note: The optimal lag prior to the rupture was 15 months.
Source: Office of the Financial Superintendent of Colombia.

Graph B4.2
Activation thresholds: past-due loan portfolio



Note: lambda follows the Ravn and Uhlig rule (129600).
Source: Office of the Financial Superintendent of Colombia.

a performance that was widespread among the different loans modalities.

Starting with this diagnosis, the SFC designed two strategies, which were launched in July 2017. These actions were complemented by a regulatory initiative issued in September 2017.

The first strategy, which was geared to reverse the trend towards deterioration within a reasonable time frame, was based on rapprochements with thirteen institutions whose past-due portfolios were showing signs of systematic deviations from their long-term growth trajectory under the thresholds established. The dissemination made it possible to raise the awareness of the institutions with respect to the atypical nature of this performance while, at the same time, they were formally required to design and submit a

due portfolio that is higher than its long-term trend and greater than 0.75 times its standard deviation.

plan of action with corrective measures for each of the credit cycle phases.⁴ After the plan was approved, a period of observation started in which the effectiveness of the plan in furthering a gradual convergence of the past-due loans with the channel of targeted individual growth was evaluated. In the case that the deviation persisted, the SFC would invoke its authority to request a reinforcement of the capital or impose restrictions on the distribution of profits at the end of the accounting period.

The second strategy, which calls for the proper disclosure of the risk of the commercial loan portfolio, is based on an internal rating that generates warnings after data on indebtedness and loan portfolio quality are compared to the debtor-level financial information provided by the Superintendent of Corporate Affairs and Economic Solidarity. Within the framework of this strategy, which involved 17 institutions between 2017 and 2018, working groups were set up to discuss the findings and promote better risk disclosure practices. In addition to the periodical updating of the rating, the financial situation of the debtors linked to the mass transportation and residential building subsectors was evaluated for the eight institutions with the most exposure to these subsectors.

To supplement this, External Circular 026/2017, which focused on maximizing the recovery, was issued. This norm introduced innovations on five fronts: i) the formalization of the concept of early default⁵; ii) the difference between structural (restructuring) and circumstantial (modification) deterioration; iii) the homogenization of practices that hid standardization⁶ to avoid signaling restructuring; iv) the adoption of special monitoring periods; and v) the inclusion of strict requirements in the case of failure to comply with the new conditions.

2. The Balance of the Measures

The gradual return of the non-performing portfolio to its long-term trajectory and the strengthening of the process of risk disclosure confirms the effectiveness of the measures taken (Graph B4.3).

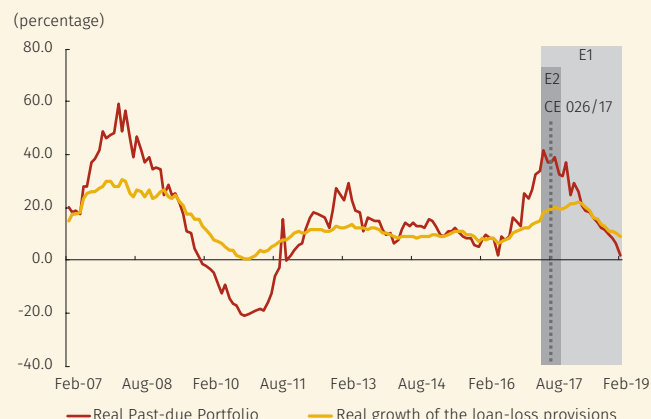
In addition, the estimates show that, even though the disconnection between the gross and non-performing still persists, the present relationship has lost strength and, in its place, the optimal lag that had traditionally been seen

4 Origination, follow-up, and recovery.

5 Those debtors who do not have consecutive defaults of more than 60 days during the last 6 months for the microcredit and consumer portfolio, and of more than 90 days for the commercial and housing ones. The equivalent for the European Banking Authority (EBA) is the recent non-performing loans (up to 90 days past due).

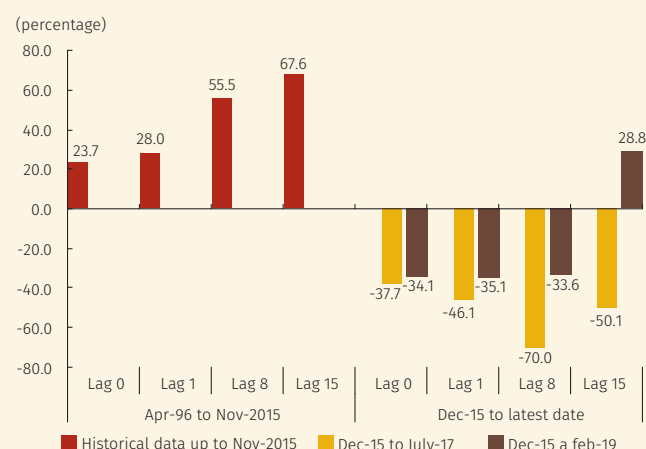
6 Such practices received different names such as “novations”, refinancing, etc.

Graph B4.3
Implementation of the Measures vs. Real Growth of the Non-Performing Loan Portfolio and Loan-loss Provisions



Note: Ei: Strategy 1 or 2. The width of the bars denotes the period that the strategy was in effect.
Source: Office of the Financial Superintendent of Colombia.

Graph B4.4
Correlation Between Non-performing and Gross Loan Portfolios for Different Periods in the Sample



Source: Office of the Financial Superintendent of Colombia.

has once again evinced a direct response though it still is not statistically significant (Graph B4.4).

Regarding the first strategy, eleven of the thirteen institutions that had to submit a plan of action experienced a correction and/or adjustment in the growth of the past-due portfolio to its long-term trend in late 2017.⁷ In general, the measure did not cause substantial changes in the past due loan policy. In place of it, the common denominator of the plans was centered around reinforcing the policies adopted over the course of the credit cycle. Regarding origination, the adjustments in the appetite for risk, the policies of approval and profiling, and improvements in gauging

7 In one case, the SFC ordered that the historical percentage of retained earnings be maintained and, in another, that a specific percentage of minimum capital adequacy be maintained.

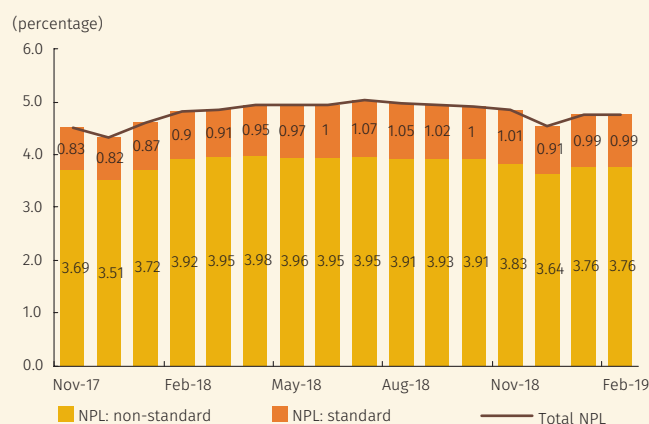
creditworthiness are notable. In follow-up, the analysis of the debtor's habits was strengthened. The better recovery reflects the development of models of default prevention management which include undertaking regional brigades.

The combination of warning plans and sector analyses in the second strategy that was geared towards strengthening the risk disclosure processes led to almost COP 760 billion in increases in loan-loss provisions between 2017 and 2018.

The major contribution of the regulatory initiative was the standardization of recovery practices and alignment of consumer and institution incentives. However, the main challenge was to evaluate its effectiveness through objective indicators.

From the time it went into effect until February 2019, the balance of the standardized loan portfolio reached COP 21.5 trillion,⁸ of which COP 4.12 trillion correspond to modifications. During this same period, the rate of success, i.e., the modified and restructured balance that remains up-to-date in comparison to the standardized total exceeds 74%. As a result, the contribution to the quality indicator by default of the transactions for which standardization was flawed has remained relatively stable at about 1pp (Graph B4.5).

Graph B4.5
Non-Performing loan indicator (NPL)



Source: Office of the Financial Superintendent of Colombia.

In addition to these figures, the Circular has encouraged improvements in credit establishments' risk management with positive effects for the consumer. At the level of industry, the regulations caused synergies between the origination and recovery functions as well as reinforcement of the follow-up infrastructure for these transactions. The transition from an industrialized approach to a "relational" one, in turn, made it possible for the consumers to decide when to approach the institution to discuss their difficulty in mee-

ting their financial commitments and provide evidence to show their ability to comply with the new terms of payment.

3. What is the Focus for 2019?

It is undeniable that the adoption of the measures described led to the achievement of the objectives set. However, there are factors inherited from 2018 that could exacerbate credit risk in 2019. In particular, the growth of the loan portfolio has been based on households given the persistent contraction of the commercial loan portfolio.

The above suggests that the incentives are given so that the institutions will venture into higher risk niches and into segments in which they may have less experience. That is why monitoring in 2019 with regard to credit risk is defined on two axes: i) foster healthy growth of the loan portfolio and ii) reinforce the achievements of the disclosure strategy.

With regards to origination, the SFC designed early warning indicators based on the performance of the static pools. These measures, differentiated at the level of institution and product, analyze the permanence, the emergence and direction of: 1) the unusual growth of disbursements, and 2) the material deviations with respect to the historical performance of quality by static pool in three- and six-month time frames.⁹ Depending on the type of warning (disbursements and/or early deterioration) and its persistence over time, the institution's specific situation is specified and if necessary, adjustment plans are established. The measure is preventive in nature in that it identifies the cause of the deterioration and suggests its timely adjustment.

Regarding disclosure, the SFC will continue to move ahead on their efforts to ensure that the rating granted by the institutions is consistent with both the situation in the sector and the debtor's financial situation.

Finally, as part of the plan for Risk-based Supervision, the SFC will remain alert to the emergence of new risk factors that could jeopardize the stability of the institutions being monitored and will design strategies they deem prudent to adopt in order to mitigate them.

8 Of this total, 62% corresponds to commercial, 28% to consumption, 7% to housing, and 3% to microcredit. In line with the effect of the cycle on the activity, the sectors that accounted for the standardized balance were construction (22%), industry (16.5%), and transportation (11.2%).

9 This time frames makes early detection of deviations in quality possible. It was considered to take the average, maximum, and minimum per entity and per product in a moving time horizon of four years. Subsequently, two warning zones were defined: orange (one standard deviation above the average) and red (between one standard deviation and the worst static pool indicator).