MicroRate Research

Practices increasing the credit risk

Practices such as an unusually fast growth in a complex context, risky credit operations approval, commercialization of loan credit assets and parallel information systems affect, sooner rather than later, the credit risk. In accordance to Microrate's experience, an inappropriate management of assets' quality has a direct impact, not necessarily immediate, on the financial institutions' (FI) financial health.

Each FI defines its risk appetite. Generally speaking, FI's will raise their lending rates to compensate the risk and also may resort to ways of managing their assets. In many occasions, the key objective is getting apparently better indicators.

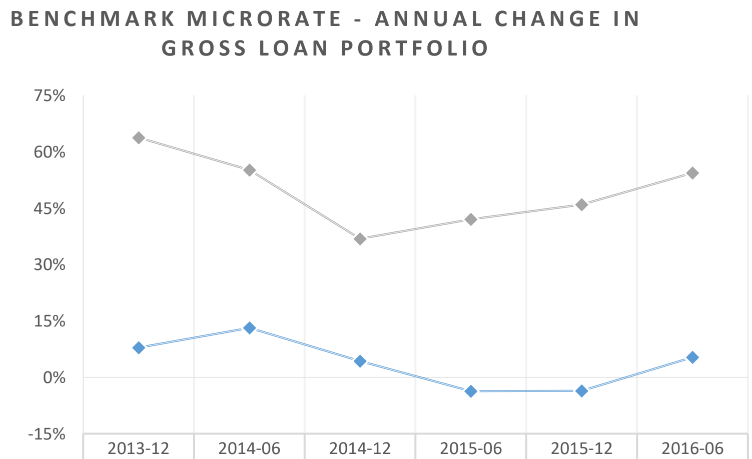
In accordance to Microrate's experience, one of these actions includes accelerating growth of loan portfolio far above the average growth rate of the local market. In exceptional cases, such disproportionate portfolio growth can be the result of a product for which there is unusually high demand in the market. More often it is an attempt by the FI to dilute costs and bad loans

A high expansion rate when the context moves in an opposite direction is often a sign that the credit risk could be underestimated.

Table 1 - Latin America Loan Portfolio Indicators

	AVERAGE	UPPER LIMIT
Annual Change in Gross Loan Portfolio	5.3%	**54.3%**
Annual Change in Number of Loans Outstanding	5.8%	**46.5%**

Source: Benchmark MicroRate June 2016



	2013-12	2014-06	2014-12	2015-06	2015-12	2016-06
Average	7.9%	13.1%	4.3%	-3.7%	-3.6%	5.3%
Upper Limit	63.7%	55.1%	36.8%	42.0%	45.9%	54.3%

Measuring the context with average indicators for peer entities helps to identify the institution's risk appetite. According to the Benchmark MicroRate, there is a strong deviation of those who are in the upper limit with respect to the average. A high expansion rate is unlikely to sustain over time and there will not be enough Portfolio Yield[1] supporting the initially attractive increase in financial revenue.

[1] Portfolio Yield is calculated by dividing financial revenue from loan portfolio by the period average gross portfolio.

Table 2 - Latin America Loan Portfolio quality ratios

	AVERAGE	UPPER LIMIT
Portfolio at Risk / Gross Loan Portfolio	6.7%	**21.3%**
% Refinanced Loans / Portfolio at Risk	23.0%	**67.9%**
Write-offs / Gross Loan Portfolio	2.9%	**18.7%**

Source: Benchmark MicroRate June 2016

Placement of riskier loans is a commonplace practice in recent years. In MicroRate's long experience, with such cases, it is often a result of ambitious positioning and profitability goals. Such high-risk loans go under a number of different names, which often hide their real nature.

In extreme case, most of a loan portfolio may be made up of high-risk loans disguised by names which give no hint of their real nature. The underestimation of the loan portfolio quality prevents the financial institution from knowing its credit activity's performance and sustainability.

The commercialization of credit assets, sometimes related to liquidity needs, has a number of collateral effects on credit risk management. Should the FI sell a portfolio in arrears very frequently, problems in credit management should be anticipated. The internal credit placement culture will get weak, and it is very likely that commercial management will not seek quality in new credits, since those which perform badly will end up separated from the institution.

Should the FI buy a loan portfolio, even if it does not assume the credit risk, without adequately verifying or controlling the quality of these credits, then the risk is obvious. Knowing the borrower is a core principle in financial business.

Often, such portfolio purchases are driven by a need to improve key indicators. Nonetheless, if the loan portfolio quality is not well assessed, the consequences will go far beyond the financial sphere. The damage would also impact on issues related to strategic planning, organization and management control.

Identifying parallel accounting or parallel IT systems is especially difficult. Regardless of the FI's size, the task becomes more complex in sophisticated systems, without excluding small institutions with simpler systems.

When the FI is migrating to a new system, the designing of access profiles may be weak and the aggregated data provided incomplete, which creates the possibility for fraudulent practices.

In some cases, the new system tends to show new credit records for old clients who were performing badly in the old system. If these cases are detected, the damage is often irreversible: Funders and clients will have lost trust in information provided by the FI.

To rebuild this trust takes a long time and many institutions will not have the financial strength to survive such a situation.