THE CREDIT SITUATION IN COLOMBIA FROM THE STANDPOINT OF THE FINANCIAL SECTOR

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INTRODUCTION

To complement a number of studies done in Colombia, based largely on figures from institutional balance sheets, *Banco de la Republica* has conducted three surveys to date on the credit situation in Colombia. The aim is to collect qualitative information that can be used to determine how financial institutions feel about different aspects of the credit business. The questionnaire for the credit survey done in November 2005 was filled out by the commercial and/or credit vice presidents of 18 credit institutions. The other two surveys, which are similar, were conducted in 2001 and 2003, making it possible to compare the results found at different stages of the economic and credit cycle.

One of the primary objectives of the present study, which is the result of an assessment and analysis of the survey, is to determine if credit dynamics respond more to supply factors than to demand, and if these - particularly the supply factors - have changed in recent years. With this information, it is possible to assess the presence of credit rationing in the Colombian economy.

The survey of the credit situation contains information on how institutions perceive access to credit in the economy and in its different sectors, their outlook, and how easy it is to identify good clients. This same analysis was done according to company size. Questions were asked about how credit institutions might use their surplus liquidity and how they perceive the risks associated with such uses. There also were questions on loan assessment by financial institutions.

The findings of the survey suggest that financial institutions continue to believe the outlook for most sectors of the economy is good, which suggests the demand

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for credit might continue to grow. However, not all sectors or companies of different size have the same expectations or the same conditions for access to credit. Information-related problems, especially for the farming and livestock sectors and, to a lesser degree, for the export sector, play a major role in identifying good clients and the expected profitability of projects.

The findings suggest there are fewer supply restrictions. However, several exceptions arise in the tradable sectors. This contrasts with the sectors characterized by supply restrictions (non-tradables) in past years, and may be related to trend and expectations concerning the exchange rate.

Shortly after the financial crisis in 1998-1999, the huge losses experienced by Colombian financial institutions seriously reduced their capital, curtailing credit growth. This situation, and the exacerbation of risk, generated a marked preference for low-risk liquid assets (e.g. TES), dampening credit activity.

The evidence now suggests that financial institutions are much less adverse to credit risk, and most restrictions on the credit supply have disappeared. According to the latest survey, the perception of risk with respect to consumer credit and mortgage loans has declined, contrary to earlier surveys, where these types of loans were considered riskier than commercial credit.

Unlike the post-crisis era, current requirements for loan approval are far more lax, and project feasibility and profitability are important elements for a decision on credit. So is knowledge of the client and his credit history.

I. ECONOMIC AND CREDIT ACCESS OUTLOOK

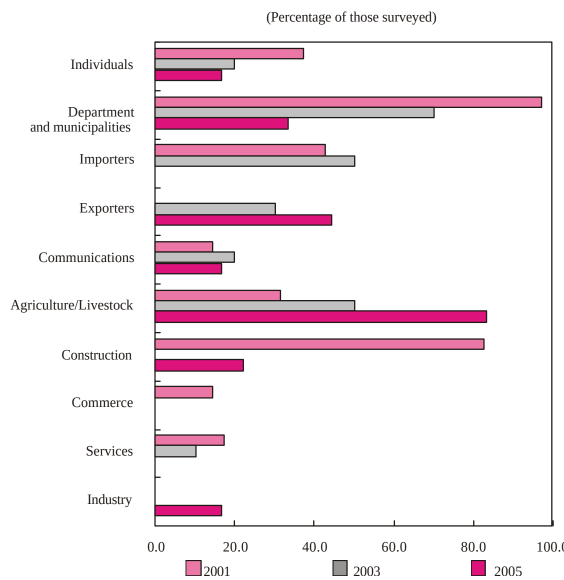
There are high expectations regarding economic performance. More than half the credit institutions (56%) believe the economic outlook for the next two years has improved, 33% expect current conditions to continue, and 11% expect them to deteriorate.

Regarding sectors, most credit institutions believe economic growth will be spurred by services, commerce, communications and imports. The perception is that these sectors are doing better than the average for the economy as a whole. In contrast, less-than-average growth is anticipated for agriculture/livestock and exports (Graph 1). Other sectors, such as industry, construction, departments/municipalities, and individuals, are expected to grow at a rate similar to the economy.

There appears to be a close correlation between sector prospects and the perception of access to new credit on the part of financial institutions. Graph 2 illustrates the trend, between 2001, 2003 and 2005, among those surveyed (as a percentage of the entire sample) who believe that specific sectors have problems with credit access. Most companies and institutions believe credit access in almost every sector is similar to the average for the economy. The only exception is the agricultural/livestock sector, which is perceived as having less-than-average access to credit and less momentum than the economy as a whole. Most financial intermediaries (83.3%) also see it as being less profitable. This close correlation is also evident in earlier surveys, but with respect to other sectors. For example, in 2001, most of the problems with prospects for the economy and credit access were concentrated in the construction sector and in the departments and municipalities.

GRAPH 1

SECTORS WITH PROSPECTS BELOW AVERAGE FOR THE ECONOMY



Source: Credit Situation Survey, Banco de la República.

It is interesting to see how financial institutions have changed their preferences in terms of the different sectors and their access to credit. This might be linked to the exchange rate trend. For instance, in the survey done for 2001, when the exchange rate depreciated sharply, expectations and favorable conditions for access to credit were centered primarily in the tradable sectors (exporters and industry). However, in the 2005 survey, good prospects were concentrated largely in the non-tradable sectors.

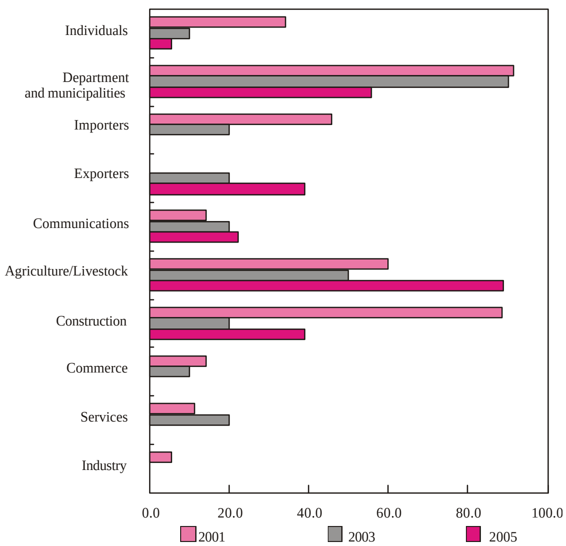
Unreliable information for identifying good clients (Graph 2B) is a determining factor for financial intermediaries and explains the difficulty the agricultural/livestock sector has in gaining access to credit. The commercial and industrial sectors have the same problem though at a lesser degree. The direct correlation between difficulty in identifying good clients and increased credit-access restrictions is evident as well (Graph 2).

GRAPH 2

PROBLEMS WITH CREDIT ACCESS AND IDENTIFYING GOOD CLIENTS

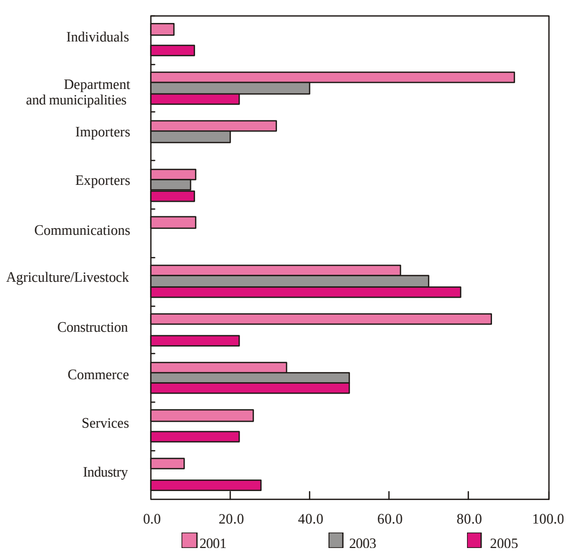
A. ACCESS TO CREDIT BELOW AVERAGE FOR THE ECONOMY, BY SECTORS

(Percentage of those surveyed)



B. SECTORS POSING PROBLEMS FOR IDENTIFYING GOOD CLIENTS

(Percentage of those surveyed)



Source: Credit Situation Survey, Banco de la República.

When the analysis is performed according to company size[1], there was no major difference in the opinion with respect to economic outlook. Most financial institutions expect the growth of small, medium and large companies to be similar to the average rate of economic growth. Each of the institutions was asked the financial sector's credit preferences in terms of company size and if they have any preferences in this respect (Graph 3). The results suggest that, although the perception of credit access in the financial sector favors the big companies (as would be expected), on an individual level (by institution), this sector appears to cover the entire spectrum of companies with no size discrimination.

In short, there are contrasts in terms of access to credit at the sector level. These are explained by differences in the prospects and profitability of economic sectors, and by problems with identifying good clients, particularly in the case of the agricultural/livestock sector. Regarding size discrimination, problems are perceived with access to sources of financing for small companies and privileged credit access for big companies.

II. LIQUIDITY SURPLUS AND RISK PERCEPTION

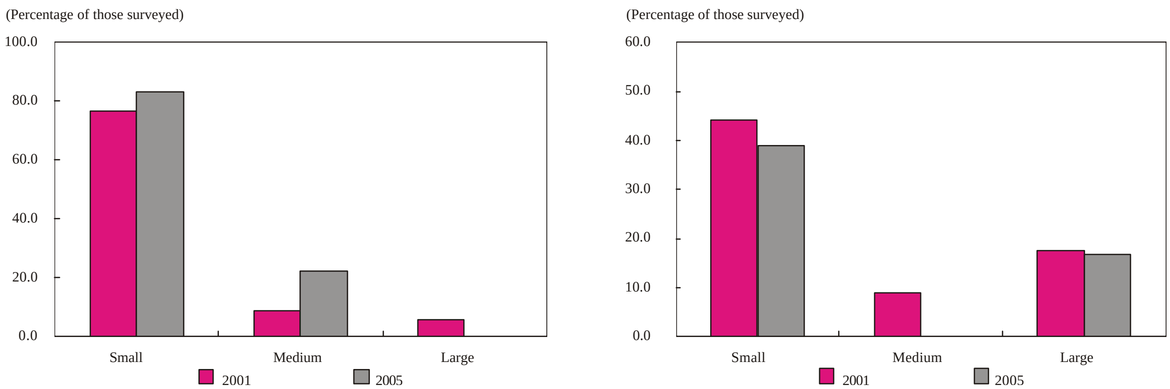
In the presence of credit rationing, financial institutions would prefer to invest their surplus liquidity in low-risk securities (e.g. TES), rather than to expand their loan portfolio. The preferences of financial intermediaries concerning the use of liquidity surplus are analyzed in this section (Graph 4), and are different from those perceived during the period after the crisis in the late nineties (1998-1999). Therefore, the acquisition of highly liquid and low-risk assets remains typical of the behavior in the financial sector, although less so.

[1] Small companies are defined as those with less than 50 employees. Medium-sized companies have 50 to 200 employees, while large companies have more than 200.

Credit Access Problems by Company Size

A. Perception of Below Economic Average Access to Credit in the Financial System, by Company Size

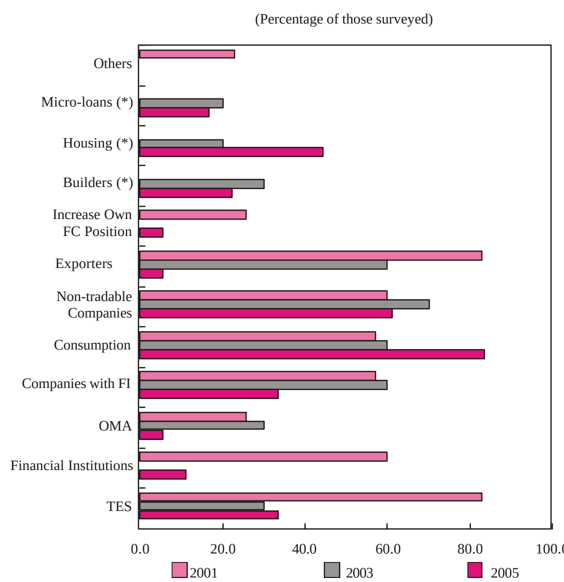
B. Particular Institution's Perception of Below Economic Average Access to Credit, by Company Size



Source: Credit Situation Survey, Banco de la República.

The next question concerned the most frequent or probable use of liquidity surplus, considering the risk. Acquisition of government securities, loans to financial institutions and placement of resources with Banco de la República were classified by banks as the least risky. Medium-risk activities include consumer loans, loans to companies producing for domestic and foreign markets, and home loans (the perception of risk on the latter is down considerably from what the earlier surveys showed). The riskiest activities include transactions to increase the bank's foreign currency position and the placement of micro-loans, loans to construction companies, loans to territorial entities and to government-owned companies. In absolute terms and compared to mortgage loans, risk perception on consumer loans was down (Graph 5A), as it was on loans to non-tradable companies compared to those producing tradables (Graph 5B).

Most Probably Use of Liquidity Surplus



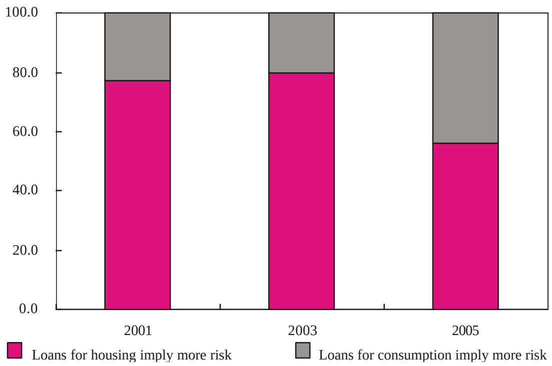
(*) This option was not included in the 2001 survey.
Source: Credit Situation Survey, Banco de la República.

Graph 5

Risk Perception

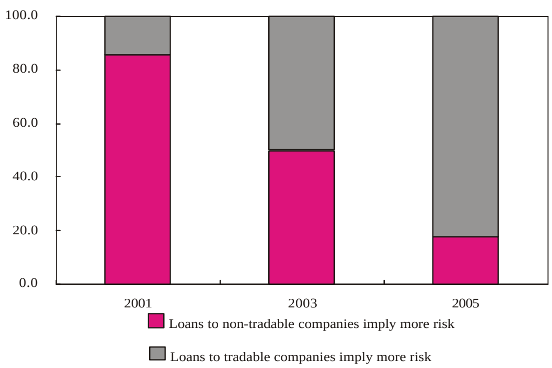
A. Loan Risk Perception: Consumer vs. Housing NDA

(Percentage of those surveyed)



B. Company Risk Perception: Tradables vs. Non-Tradables

(Percentage of those surveyed)



Source: Credit Situation Survey, Banco de la República.

Reorientation of the credit business has prompted financial institutions to shift their liquidity surplus, particularly in the case of institutions that specialize in mortgage loans. The shift is from mortgage loans to consumer and commercial loans. However, preservation of the market segment is still the most important factor in the portfolio decisions of credit institutions.

In conclusion, financial institutions will most likely use their liquidity surplus based, to some degree, on the perception of less risk. Accordingly, the perception that micro-loans are high risk explains some of the problems small companies have with credit access. Moreover, activities once considered extremely risky – such as consumer credit – are gaining acceptability among financial institutions, clearly prompting a portfolio shift in assets from investments in highly liquid securities to loan placement (particularly consumer loans). There also has been a noticeable recovery in mortgage loans, as financial institutions now consider them to be less risky. This suggests that the main features of the credit crunch, which were identified in earlier surveys, are disappearing and the current low growth in mortgage loans is perhaps more the result of demand constraints than supply problems.

III. REJECTED CLIENTS AND RISK-ASSESSMENT CRITERIA FOR CREDIT ALLOCATION

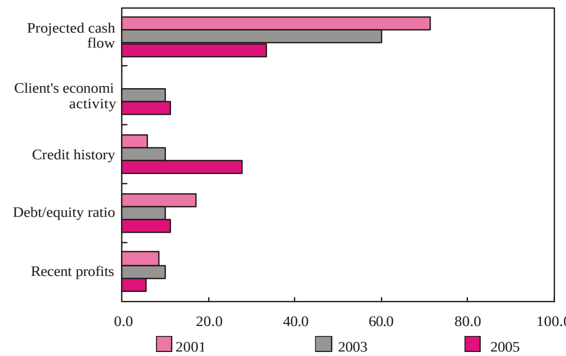
When asked how a new client's risk is assessed, the two most important criteria mentioned by financial institutions were the client's credit history and projected cash flow (Graph 6). For example, 61.6% indicated these are among the three major criteria. However, an attempt to rank them in order of importance proved inconclusive. Other criteria such as business sales, recent profits, the debt/equity ratio, collateral and the client's economic activity appear to be less relevant to financial intermediaries when assessing credit risk.

In a credit crunch, one should expect the client's credit history to be more important than the project's cash flow. The risk assessment done by financial institutions shows that the client's credit history has become more important, in relative terms, than projected cash flow; however, the latter is still considered fundamental (Graph 6). In any case, the results are not conclusive. When financial institutions were asked about the criteria they consider for approving a loan, credit history acquires more importance than the project's cash flow and profitability.[2]

GRAPH 6

THE MAIN CONSIDERATION IN RISK-ASSESSMENT FOR NEW CLIENTS

(Percentage of those surveyed)



Source: Credit Situation Survey, Banco de la República.

In the case of clients whose application was rejected, the institutions surveyed were asked whether or not they would have approved the loan if the client had agreed to a higher interest rate. The majority (83.3%) said no. A similar percentage said the same in the earlier surveys. When asked what they would have done had the client been willing to accept a shorter loan, most of the institutions surveyed said they would not have agreed to the loan.

When asked if they would have granted the loan, had the client offered more collateral, 66.7% answered affirmatively. This response appears to be somewhat contradictory to the answer to earlier questions, where collateral appears to be less important when assessing a loan request. However, the findings of earlier answers - more insistence on the quality and amount of collateral, and denial of credit despite the client's willingness to pay a higher rate of interest and/or to accept a shorter loan - are consistent with the characteristics of credit rationing. Consequently, there is evidence that vestiges of the credit crunch that occurred after the last financial crisis still exist or, at least, that certain practices indicating the presence of a credit crunch remain in place.

As to the particularities of clients whose loan applications were rejected, the financial institutions surveyed indicated that most were new clients. Again, this suggests the client's credit history is key to loan approval decisions.

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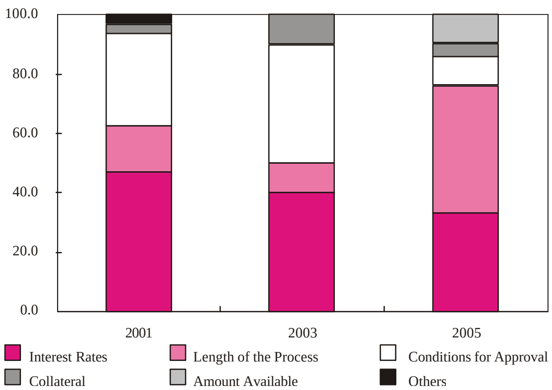
2 For 77.8% of those surveyed, good information on the client's credit history was the most relevant, followed by low risk (11%) and profitability of the project (5.6%). None of the institutions surveyed mentioned the existence of satisfactory collateral as a key reason for approving a loan.

GRAPH 7

THE MOST RECURRENT COMPLAINTS OR COMMENTS RECEIVED BY FINANCIAL INSTITUTIONS

(Percentage of those surveyed)



Source: Credit Situation Survey, Banco de la República.

Complaints from clients about the process financial institutions use to study a loan application constitute another topic (Graph 7). The most recurrent complaint is that the procedure is too long. Moreover, a third of the institutions surveyed said the most common complaint is high interest rates. Complaints about the conditions for loan approval and the kind of collateral required (which is considerable) appear to be less frequent.

This contrasts with the earlier surveys, (Graph 7), where the most recurrent complaints from clients involved strict conditions for loan approval. In short, the client's credit history and the project's cash flow are the most important factors credit institutions consider when evaluating a loan application. Constraints involving high interest rates and strict conditions for loan approval seem to have become less important.

IV. EFFECTS OF AN INCREASE IN CREDIT DEMAND AND FACTORS THAT DETERMINE FINANCIAL ACTIVITY GROWTH

As part of the survey, financial institutions were asked how the credit supply would most likely react to an increase in the demand for loans, represented by a rise in economic activity. Among the three most likely events, 77.2% indicated the system could meet the demand for credit without a great deal of strain. However, 55.6% of those interviewed said small and medium-sized companies likely would face credit bottlenecks, while 50% cited the possibility of constraints to access for certain sectors.

The survey also included questions on how institutions perceive the factors that prevent – or could prevent – the Colombian financial system and each institution in particular from extending more credit to the private sector, and the actions or events financial institutions regard as necessary to increase the amount of credit in the economy.

With respect to the factors that limit credit growth (Graph 8), the main problem mentioned by most of those interviewed is the client's creditworthiness or ability to pay. Half the institutions surveyed point to the shortage of low-risk projects as another major constraint. Legal instability and lack of financial information on new clients are also significant limitations.

Compared to the results of the 2001 survey (Graph 8), there has been an improvement in the perception of clients' ability to pay and their economic activity. Provisioning and legal instability were considered more important by credit institutions in 2001, although they are currently cited by many as factors that limit credit growth.

Another question concerns the actions or events financial institutions regard as necessary to increase the amount of credit in the economy (Graph 9). In this respect, 83.3% of those surveyed agreed an increase in economic activity would be one of the three factors that would raise credit, while 50% insisted on legal stability. An important portion of those interviewed felt more profitable projects and better information on the applicant's creditworthiness also would result in more credit.

No credit establishment perceived central bank liquidity as a constraint to credit. Regarding interest rates, 11.1% of the institutions surveyed indicated that higher lending rates would boost credit activity. This suggests there is no conclusive evidence with respect to high price elasticity in the credit supply.

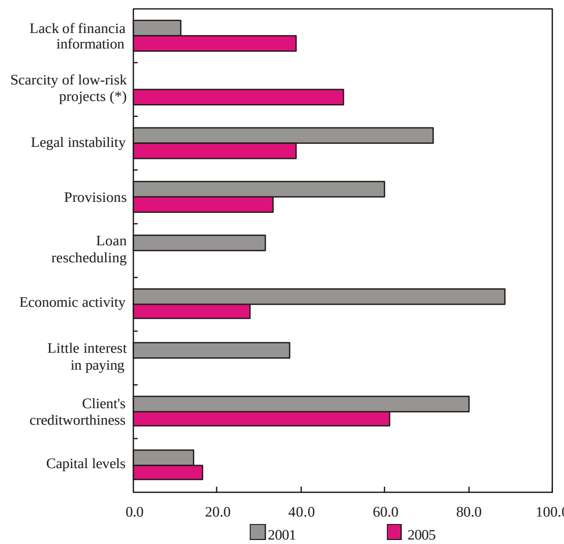
Capital constraints were an important feature during the post-crisis period, but were not relevant in this survey. No institution said that having more capital would prompt higher lending activity.

According to these findings, the private sector's demand for loans is perceived by financial intermediaries to be the primary constraint to further growth in the credit market. From the standpoint of the financial sector, an increase in economic activity would boost the demand for credit, which would be backed by the favorable situation in the sector and its willingness to loan. Consequently, an increase in

GRAPH 8

MAIN PROBLEMS FOR FINANCIAL INSTITUTIONS THAT PREVENT MORE GROWTH IN CREDIT

(Percentage of those surveyed)

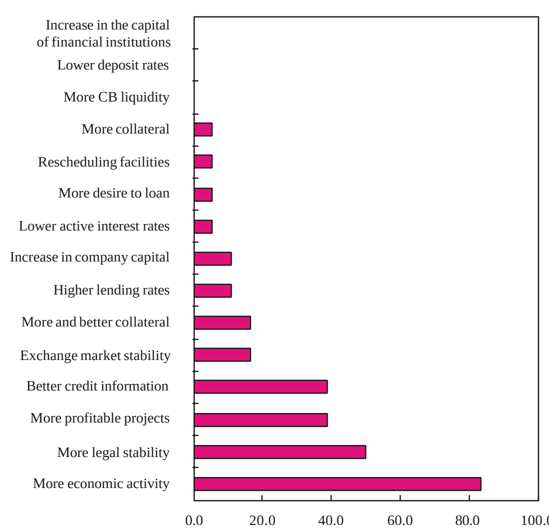


(*) This option was not included in the 2001 survey.
Source: Credit Situation Survey, Banco de la

GRAPH 9

ACTIONS OR EVENTS REQUIRED TO INCREASE CREDIT IN THE ECONOMY 2005 SURVEY

(Percentage of those surveyed)



Source: Credit Situation Survey, Banco de la República.

the supply of credit is to be expected. This would imply a new equilibrium in the credit market, where the volume of loans would increase. In contrast, legal instability, lack of financial information on new clients and their creditworthiness are supply constraints that inhibit credit growth.

V. SUMMARY AND CONCLUSIONS

The credit situation survey provides valuable qualitative information on how financial institutions perceive the credit market. This can be useful to examine the existence of credit rationing in the Colombian economy. At present, they see good prospects for most sectors of the economy, which indicates the demand for credit might continue to rise. The findings also suggest that expectations and conditions for credit access are not homogeneous across sectors and companies size. To begin with, credit access is restricted by information problems related to the client's creditworthiness and project profitability. This is particularly true for the agricultural sector and, to a lesser degree, for the export sector.

It is interesting to see how the factors that reflect the possible existence of credit rationing have changed, and how this phenomenon has been disappearing. In the post-crisis era, the huge losses accumulated by Colombia's financial system meant sharp restrictions on growth in the supply of credit, due to capital constraints. The latter generated extreme risk aversion, preference for low-risk liquid assets, coupled with an unwillingness to expand credit activities. Although financial institutions still turn to government bonds, a certain preference for loans to households and to companies that produce for the domestic market is evident.

The results of the survey show credit institutions have substantially less credit risk aversion. This may be related, among other factors, to more client information, increased economic activity and more risk control. This has allowed for a noticeable reduction in supply constraints on the credit market. Consumer credit and mortgage loans have been favored in this sense, thanks to a lower risk perception, particularly with respect to mortgage loans. However, the demand for mortgage credits does not appear to be related to the pace of supply.

The requirements for gaining access to credit are another aspect that identifies the existence of a credit crunch. When there are supply problems, the requirements would be expected to increase. However, in contrast to past years, the perception is that requirements for loan approval are less strict.

Although the features of a project (such as viability and profitability) appear to be important for loan approval, the highest priority is related to prior knowledge of the client and his credit history. Consequently, new clients with insufficient information are the ones that face more credit access restrictions. As those clients acquire a history of credit with the financial system, they will become less sensitive to a credit crunch.

Finally, the results point to disappearance of the factors that hamper access to credit, at least those concerned with limited capital and credit risk aversion. The problem with the credit market seems to be more serious on the demand side, especially for mortgage loans. Nevertheless, there also are indications of supply problems concentrated in specific sectors (agriculture and exports) and among small and medium-sized companies.