FINANCIAL INSTITUTIONS AND THEIR IMPACT ON THE DEVELOPMENT OF CONTEMPORARY COMPANIES IN ECUADOR

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Abstract. *This paper analyzes the evolution of the financial system and private banks in Ecuador. The main objective of this paper is to present the impact of liquidity risk and credit risk in contemporary companies and financial institutions. Due to, the challenges of contemporary companies' increase, because they must be completely linked to the needs and demands of consumers, society itself, focus on globalization. The company faces challenges every day as integrity, cash, borrowing, and resource management, increased selection and competition, uncertainty, regulation, globalization, among others. Therefore, that is the reason companies must be prepared because the right path yesterday may not work today and could be a disaster by tomorrow according to Neal Jensen. The methodology used is a combination of extensive literature survey and analysis of data. In addition, the paper presents liquidity risk and credit risk management for banks. The financing from financial institutions plays an important role in contemporary companies, in the development and sustainability of projections, innovations, and development. Nonetheless, financial institutions must be solvent and solid, in which, the funds required by enterprises are very useful and allow them to minimize the risk and face the uncertainty of the future. Whereby, it is important to know some principles that help financial institutions to manage their liquidity risk, especially decreasing their risk management. Funding to contemporary business is vulnerable to several factors that occur in the economy of a country, among which are mentioned: diversifiable risks as non-diversifiable, transaction costs and loan guarantees. The financial problems in Media Industry are analyzed. Financial institutions whether small, medium or large, play a role very important in an economy because they take advantage of market opportunities in their favor and constantly moving the flow of money, being an engine for developing economies and developed countries because a liquidity financial shows solvency for investment. Liquidity financial should also be emphasized that financial institutions in an economy allow increasing lending to companies.*

Keywords: *financial institutions; contemporary companies; liquidity risk; credit risk development; management.*

Introduction

The challenges every business faces every day are integrity, cash, borrowing, and resource management, increased selection and competition, uncertainty, regulation, globalization, among others. Therefore, that is the reason companies must be prepared because the right path yesterday may not work today and could be a disaster by tomorrow according to Neal Jensen who was mentioned in Forbes magazine (2013).

The World Economic Forum (2015) found the three main problematic factors for doing business in Ecuador are restrictive labor regulations (14.5), tax rates (13.7) and complexity of tax regulations (12.2), among others specified in Figure 1.

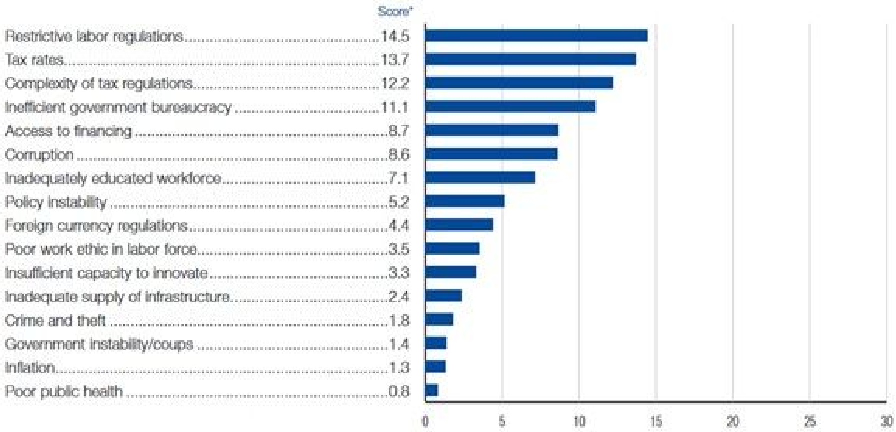


Figure 1. The most problematic factor for doing business in Ecuador (2015)

Financial problems as Cash, borrowing, and Resources Management mentioned by Neal Jensen, "becomes even more important during recessionary times when cash is flowing more slowly into the business and creditors are less lenient in extending time to pay" (FORBES, 2013). In addition, cash flow challenges are intensified by the lending climate, principally for small businesses. According to ASOBANCA (2016) showed that the Country Risk (EMBIG) in Ecuador at the end of June 2016, had an average country risk of 893 points (see Figure 2). That is, a decrease of 20 basis points compared to May. While there was an increase of 118 points compared to June last year.

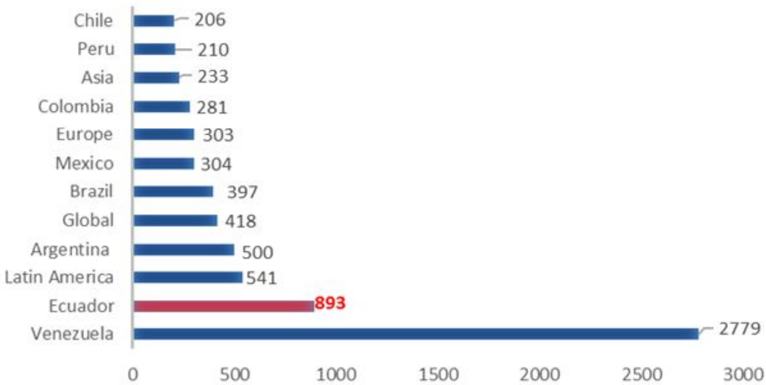


Figure 2. Country Risk (Jun/2016)

Nevertheless, Neal Jensen argued that "Problem Solving and Risk Management is a major challenge for all companies is identifying, assessing, and mitigating risks, including human and financial capital, in addition to the macroeconomy" (FORBES, 2013). Companies must develop a robust problem-solving capability at all levels. Whereby, companies must identify and measure risks to be able to cope with financial problems. Therefore, liquid risk and credit risk will be discussed.

National financial system of Ecuador

Then, companies to obtain financing, they are turning to financial institutions to increase the flow of money and the total of their capital through investments. A Financial Institution (FI) "is an entity that is in business to, among other things, accept deposits, make loans, exchange currencies, and broker investment securities" (INVESTOPEDIA, 2015). For example, financial institutions in Ecuador (Superintendency of Banks, 2016) are Private banks (22), Insurers and reinsurers in operation in January 2015 (37), Foreign Private Bank (1), Brokerages (39), Financial companies (10), Financial groups (8), Public Financial Institutions (5), Fund managers (26), Mutualists (4) and Credit Card Issuers (2). The National Financial System of Ecuador (see Figure 3) is comprised of the following institutions: control agencies, public financial institutions, private financial institutions, financial services institutions, auxiliary services institutions.

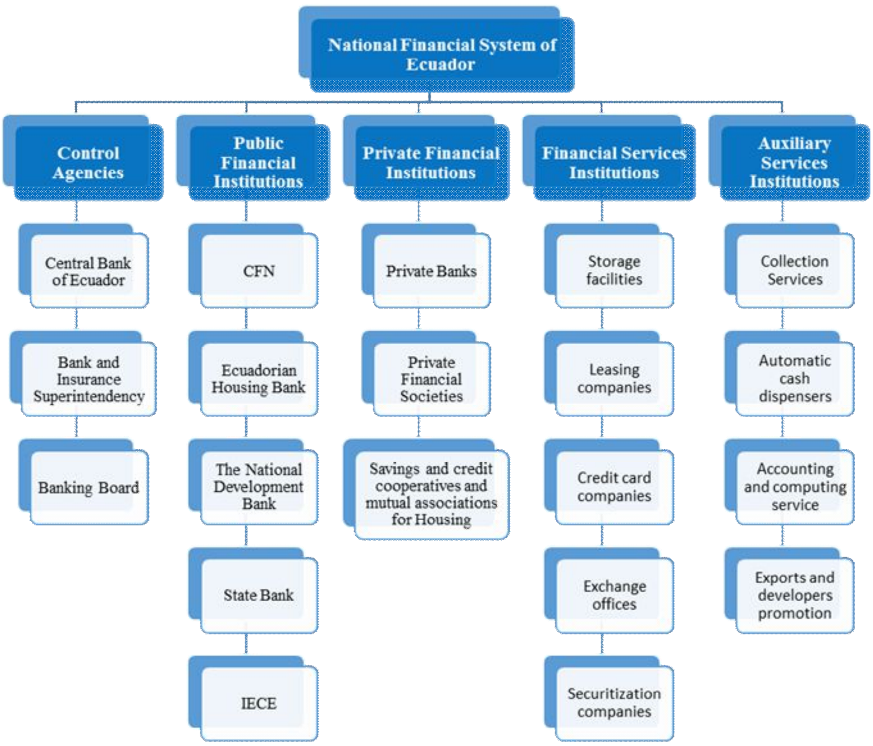


Figure 3. National Financial System of Ecuador (2016)

However, not every financial institution provides all of those services. Some just accept deposits and make loans. Others focus mainly on brokerage services. Therefore, the role of financial institutions is achieving sustainable development, "which leaves at least the same amount of capital, natural and man-made, to future generations as current generations have access to" (INVESTOPEDIA, 2015).

Financial institutions interact with the environment in a number of ways as investors, as innovators, as valuers, as powerful stakeholders, as polluters, and as victims. In that way, financial development can affect growth through three main channels mentioned by Gertrude (2003): (i) it can raise the proportion of savings channeled to investment, thereby reducing the costs of financial intermediation; (ii) it may improve the allocation of resources across investment projects, thus increasing the social marginal productivity of capital; and (iii) it can influence the savings rates of households.

Liquidity risks in Ecuador

Gómez (2015) explains that liquidity risk in a financial institution is evidence that such institution does not have cash reserves sufficient money to meet its financial obligations, in addition to this cannot meet repayments to investors and cannot satisfy the demand for settlement with their customers.

According to Islamic Financial Services Board (2012) the types of liquidity are liquidity and market financing. With regard to liquidity risk, financing refers to the inability to meet efficiently processes cash flow, operational activities and other financial obligations to expected or unexpected events that occur now or in the future. So, the outputs of money as reimbursement of deposits and investment, payments to creditors, enforcing contracts, among other activities that are performed by the financial institution in a balanced way without harming future operations.

The private banks in Ecuador have gone through its difficulties in a matter of liquidity and solidity. Due to facts as the crisis of 1999 known as "bank holiday", and the crisis of 2008. Currently for the low price of oil worldwide, the appreciation of the dollar against other currencies, the increase in VAT from 12% to 14%, and the restriction on imports (safeguards). Islamic Financial Services Board (2012) explained that this generates speculation customers, which generates an internal financial crisis, as customers withdraw their deposits money because they fear that their accounts are frozen and this can become a financial problem chain to more financial institutions because volatility changes.

Falling levels of liquidity which for December 2014 were USD3.373.7 million, then for the next year fell to USD $ 1.6408 billion, but by May 2016 rose again USD1762.5. However, Central Bank of Ecuador (2016) shows that these indicators are more a reflection of the lack of dynamism of the Ecuadorian economy. However, liquidity levels in June 2016 for USD 3234.6 million, while the previous month was USD 1045.1 this value million (see Figure 4). Changes in the liquidity of this month due to operations public sector by USD 1,762.5 million (54.5%), the private sector by USD 968.5 million (29.9%); the external sector by USD 381.4 million (11.8%); the other financial corporations by USD 109.7 million (3.4%); and other sectors by USD 12.4 million (0.4%).

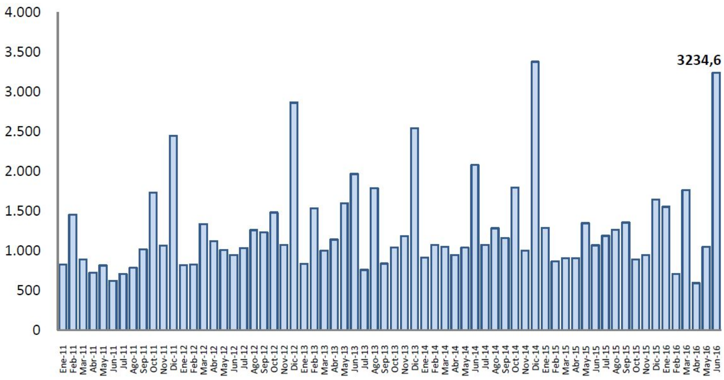
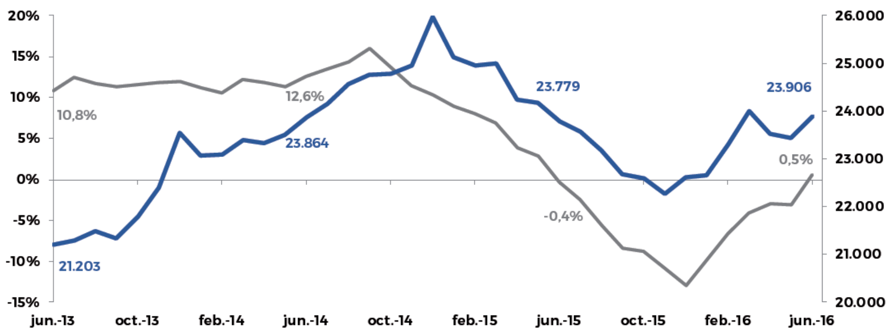


Figure 4. Financial system liquidity, millions of USD (Jan/2011-Jun/2016)

ASOBANCA (2016) informed that the balance of private bank deposits closed the first half of 2016 at the US $ 23,906,000, which meant a monthly growth 2.0% and annual 0.5%. Annually, this meant increasing from US$127 million after twelve (12) months of negative annual variation, June is the first month to register a positive variation.



------------ ***Annual change (%)*** ------------ ***Total deposits***

Figure 5. Annual change and total deposits from private banks, millions of USD (Jun/2013-Jun/2016)

Creditworthiness and image of a financial institution, allows withdrawals are lower, shows that it is a safe entity as it meets its financial obligations on time, avoid the anticipated sale of its assets and avoid resorting to alternative aid in the interbank market or central bank support because they generate costs. So, “depositors always want to have available the amount of money kept in banks and show loyalty when the institution shows good quality of services while providing access to credit” (Islamic Financial Services Board, 2012).

Liquidity risk management for banks

Whereby, it is important to know some principles that help financial institutions to manage their liquidity risk, especially decreasing their risk management. Therefore, “liquidity risk management is a key banking function and an integral part of the asset and liability management process” (Bank for International Settlements, 2008). About, the managing liquidity risk is regulated along with other types of risk affecting financial institutions, which are subject to the recommendations of the Committee on Banking Supervision (Basel III) published in Fiscal Policy Research Institute of Thailand (2010), which establishes the "Principles for the proper management and supervision of liquidity risk ", in total there are 17 principles.

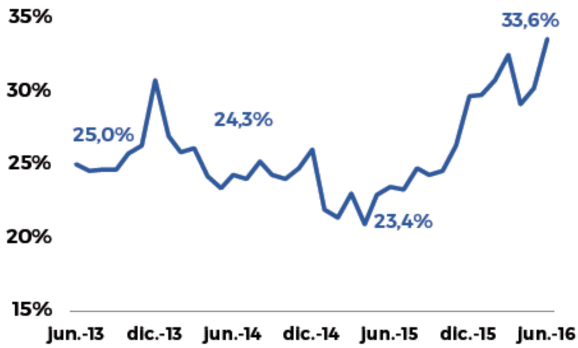
So, the recommendations on bank liquidity risk management generally emphasize on the following principles 1-7 (see Figure 6). With regard to the first principle, one bank is responsible for the good management of liquidity risk to ensure sufficient liquidity, through high-quality liquid assets as support from unexpected events that cause loss of funding. At a time Gómez (2015) argues when liquidity risk is high-risk supervisors should take measures to protect depositors and to limit damages in the financial system.

Principle 1	Sufficient capital buffer and liquidity adequacy must be provided in both regular and stress events.
Principle 2	The monitoring process should put off-balance-sheet items under observation.
Principle 3	The information system is necessary for the senior management to monitor and measure liquidity risk.
Principle 4	The diversification of funding sources and of liabilities is required for sound liquidity management.
Principle 5	Stress-testing must be conducted with a variety of “what if” scenarios, with the aim of developing efficient contingency funding plans (CFPs).
Principle 6	Each bank should provide adequate level of disclosure of information for public perception and risk-management purposes.
Principle 7	The role and involvement of supervisors in liquidity risk management is crucial. The supervisors should conduct an independent evaluation of a bank’s strategies, policies, procedures, and practices related to the management of liquidity

Figure 6. Principles for the proper management and supervision of liquidity risk

III The Basel Committee (Gómez, 2015) has published documents that allow you to manage liquidity risk and has established principles for proper management and supervision of liquidity risk. Among these documents, there are rules as the liquidity coverage ratio and tools for monitoring liquidity risk.

For example, in this Ecuadorian case, the index of private bank liquidity concerning the relationship between the funds available and total short-term deposits was 33.6% for June 2016; this ratio increased by 10.2 points percentage compared with the same month last year informed by ASOBANCA (2016).



----------- Funds available/Total short-term deposits

Figure 7. Liquidity-Private Banks, percentage (Jan/2013-Jun/2016)

Gómez (2015) advises that the liquidity coverage ratio is a coefficient to 30 days to analyze the resilience due to potential liquidity payments. By this formula, they can ensure that banks have sufficient high-quality liquid assets for any unforeseen situation.

$$\text{Liquidity coverage ratio} = \frac{\text{High} - \text{quality assets}}{\text{Net cash outflow 30 days}} \geq 100\%$$

Another indicator is the net stable funding ratio indicated by Gómez (2015), which measures the amount of stable funding sources of financial institution concerning the liquidity of the assets financed.

$$\text{Net stable funding ratio} = \frac{\text{State funding available}}{\text{Net cash outflow}} \geq 100\%$$

The Islamic Financial Services Board (2012) informed that a financial institution must have integrated and comprehensive liquidity management that integrates the processes of risk management of the company to obtain the necessary liquidity to meet daily financing activities and has funds to any anticipated event or unexpected to continue with the normal operation of the company.

According to the principles for managing liquidity risk (Fiscal Policy Research Institute of Thailand, 2010), the role of supervisors is necessary, sell assets on the market to raise money effectively to mitigate risk. There are times when the market does not have enough investors, hindering the sale of assets, which helps to increase funding liquidity risk. So, "a failure in liquidity risk management may result in a bank becoming unable to meet its obligations" (Bank for International Settlements, 2008).

Total assets (see Figure 8) at the end of June 2016, reached a total of USD $ 32,387,000, contrasting the balance obtained in June 2015 where the service reached USD $ 32,134 million. In annual terms, this account grew by 0.8%, this is the first positive change after ten months of contraction.

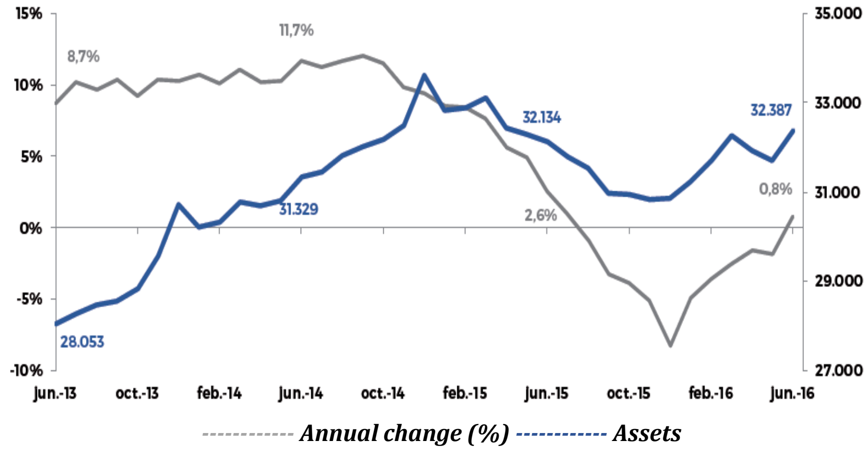


Figure 8. Assets, millions of USD (Jun/2013-Jun/2016)

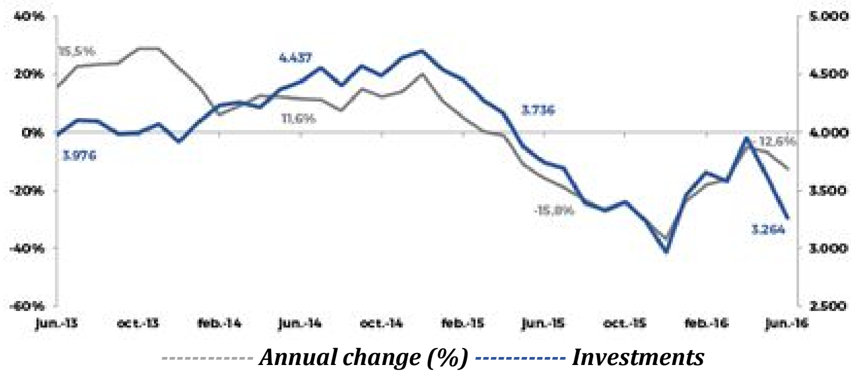
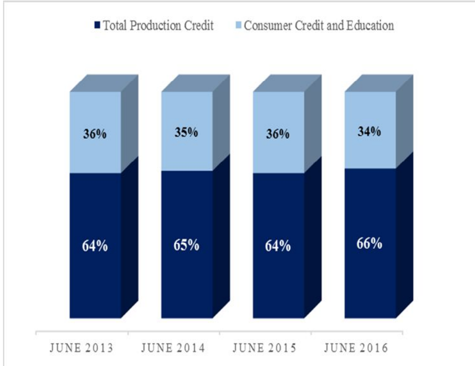
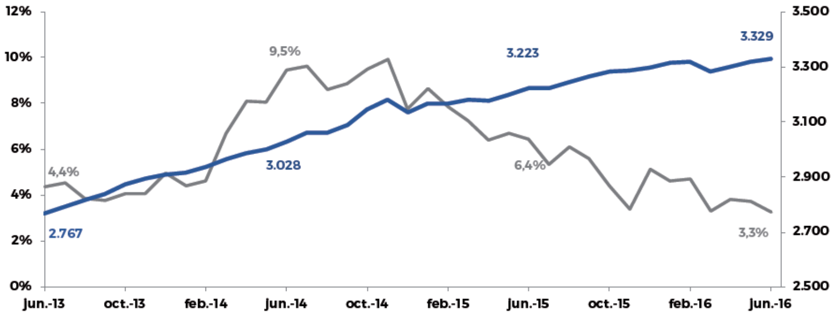


Figure 9. Investments, millions of USD (Jun/2013-Jun/2016)

The investment (see Figure 9) account recorded a surplus of USD $ 3,264 million, which meant a monthly decrease of 9.6%. In relation to total assets, investments represent 10.1%, while in June last year was 11.6%.

Destination Gross Portfolio		
Types of credit	Balance	Composition
Commercial Credit	8.698	47%
Housing Credit	1.906	10%
Microenterprise Credit	1.686	9%
Total Production Credit	12.291	66%
Consumer Credit and Education	6.413	34%
Total Gross Loan Portfolio	18.704	100%





------------ ***Annual change (%)*** ------------ ***Equity + Net profit***

Figure 10. Equity, millions of USD (Jun/2013-Jun/2016)

Figure 11. Credit Destination, millions of USD (Jun/2013-Jun/2016)

Account Private equity Banking System as of June 2016 had an accumulated balance of USD $ 3,329 million. Similarly, in annual terms, equity recorded an increase of 3.3%, which he meant a growth in the balance $ 106 million, which in turn means greater Banking solvency.

Credit in Ecuador

Credit as an important channel of financial intermediation for economic growth. Nevertheless, in times of economic crisis, banks usually have no economic losses and solvency. It is recommended that banks have sufficient resources to act as a buffer against unexpected losses. An activity of private financial institutions, granting credit is generating benefits for the institution but in turn involves various types of risks, including credit risk (Ross, Westerfield, & Jordan, 2010).

In Ecuador, ASOBANCA (2016) informed that at the end of June, the balance of credit from private banks reached a value of USD$18,704,000. Thus, the total funding provided by private banks, USD $12,291 million were allocated to production credit, with credit for the productive sectors, housing and microenterprise are located at 66 % of the total. While credit for consumption and education was 34 % of the total, equivalent to USD$6,413 balance millions.

ASOBANCA (2016) showed the rate of banking coverage (see Figure 12), expressed through the relationship between portfolio provisions against unproductive portfolio, reflecting the end of June 2016 a ratio of 1.6 times. The total provisions recorded a cumulative total of USD $ 1,320 million balance; while the unproductive portfolio was USD $ 807 million.

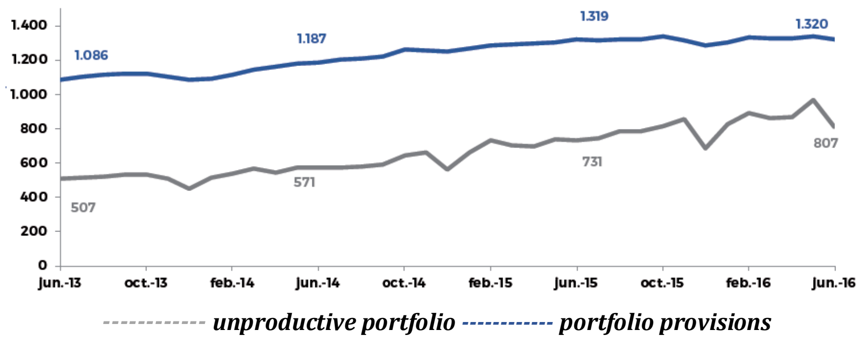


Figure 12. Banking Coverage, millions of USD (Jun/2013-Jun/2016)

Credit risk management for banks

Credit risk is the likelihood that economic to financial institutions that make loans losses are generated because the payments by the borrower are not met in a pay period established by both parties. Also, Ross, Westerfield and Jordan (2010) Found that the structure of the assets of a company determines administrative decisions on the amount of cash and inventory should have, like credit policy, acquisition of fixed assets, etc.. Cóndor and Cajamarca (2014) argued that the risk management of credit must ensure the quality of their portfolios, and also identify, measure, control, mitigate and monitor exposures counterparty risk and potential losses that could be generated, with the aim of having coverage provisions or technical heritage in the event that the credit risk increase.

The latest information available from the Bank Superintendence (BS) shows that at the end of December, qualified as A and B, overall, portfolio reached 94.95%, reflecting a portfolio of the private banking system, almost entirely, of low and moderate risk. The portfolio with a rating of C, D, and E, meanwhile, accounted for 5.05% of the total loan portfolio.

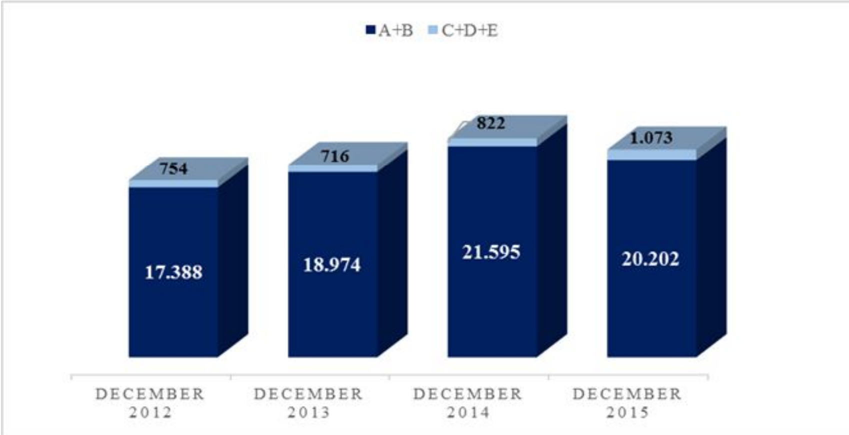


Figure 13. Bank Quality Credit (Dec/2012-Dec/2015)

Cóndor and Cajamarca (2014) contributed to analyzing the late payment that it is measured as the relationship between the unproductive portfolio to gross loans, and portfolio quality index is measured as the ratio of risky portfolios and gross loans by business line. Investors know that the credit risk can be presented by any lender, which require a higher yield to compensate for this risk. Therefore, "the financial institution must collect information and analyze the creditworthiness of the customer" (Ross, Westerfield, & Jordan, 2010) and the higher the risk of certain credit presented by the buyer, the lower the loan term.

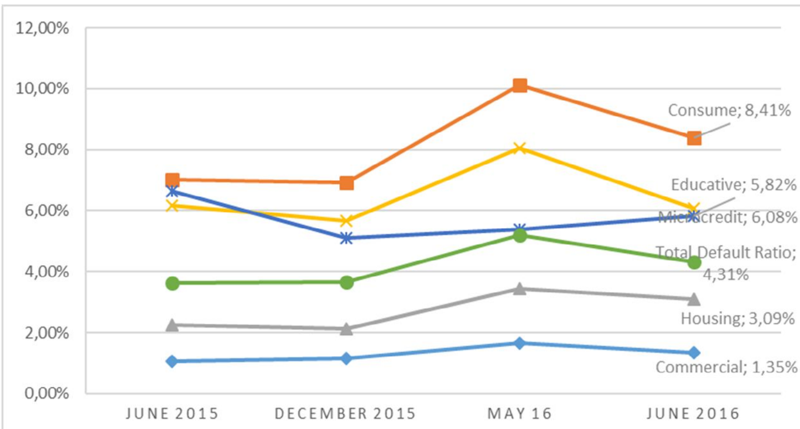


Figure 14. Unproductive Credit Portfolio (Jun/2016)

The default rate for all private banks in Ecuador (see Figure 14), at the end of June 2016 stood at 4,31%. Monthly, it is decreasing by 0.9%. Housing and trade loans are the least default rate compared to consume and small business as microcredit.

Ecuador's private banks are now more cautious in lending because this way they can maintain their liquidity. On the other hand, credit also depends on how efficient are banking assets. Widespread economic circumstances cause that households and businesses have difficulties to honor loans in a timely manner so that nonperforming loans have increased in recent months and this discourages financial institutions to offer loans with the dynamism of years above.

If a company runs out of cash (liquidity risk), it is forced to sell marketable securities and short-term cannot meet its obligations. The Fiscal Policy Research Institute of Thailand (2010) specified that without sufficient liquidity reserves, there is a risk of self and problems solved between the lending capacities occur, the economic recession and credit losses.
How reduce credit risk? it is worth mentioning that there are no formulas to assess the probability that a customer does not pay. Why there are five basic factors C are assessed credit to customers:
- Character: Refers to the client's readiness to meet its payment obligations.
- Capacity: The client's ability to meet its credit obligations.
- Capital: Liquidity customer.
- Collateral: Assets given as collateral in case the respective payments are not made by the customer.
- Conditions: general economic conditions in line with customer business or professional activities.

How risk financial institutions are protected after giving credit? When credit is granted, the financial institution monitors the lending transaction and, if it detects the possibility of losses, take a portion of money from its capital, equivalent to the expected loss, and reserves to face the damage. This reserve is known as "provision".

How a provision calculated? It is estimated, in general, credit rating with a scale, according to parameters such as timely payments, type and amount of guarantees, the behavior of the debtor's business, etc. The most common scale assigned letters from A to E to credit, where A represents a credit that will fully recover and E a loss. The company performs both ratings as provisions for each credit according to the scale at which it is found, in accordance with the regulations of the country. This is the method legally established in several countries such as Ecuador and followed by financial institutions.

Impact on the development of contemporary companies in Ecuador

Figure 15 shows that in the second quarter of 2016, the companies requesting new credit belonged most to the branches: Industry (19%) and Commerce (16%) compared with the Construction (10%) and Services (7%). This corporate behavior holds for the group of large and small businesses. In the case of micro-enterprises are Construction (11%), followed by Industry (8%) with high rates.

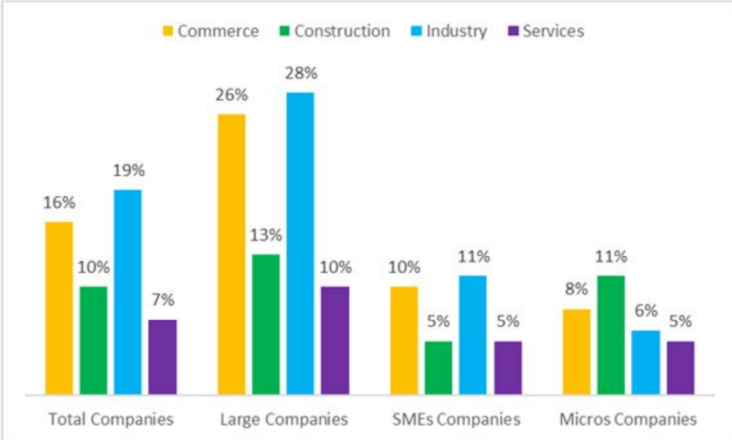


Figure 15. Companies requesting new loans (II Quarter/2016)

In the second quarter of 2016, in the group of large and micro companies as well as in the total, those belonging to the Construction sector were the most difficulties had to pay their debts (37%, 31 %, and 33 %, respectively); however, in the group of SMEs, Construction were the lowest incidence (30%).

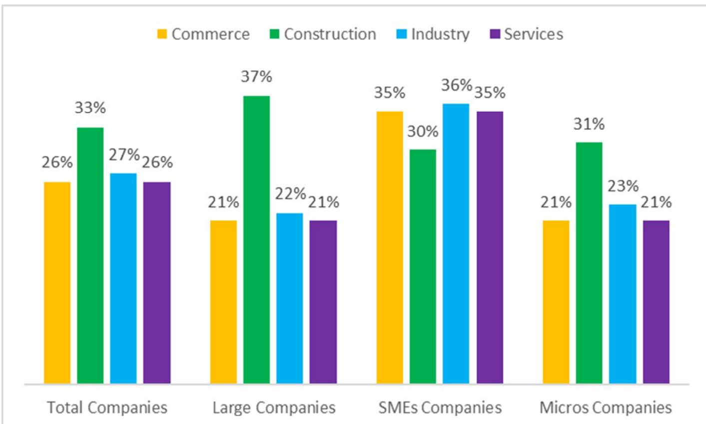


Figure 16. Companies with difficulty paying their debts (II Quarter/2016)

Financial problems in media industry

In Ecuador, many people decide to take the path of "entrepreneur" and become one of them, but there are few who succeed. This happened with the morning daily called 'HOY', company that went bankrupt after working more than 30 years. HOY won a very important place in the Ecuadorian press, for its openness to the different currents of opinion until the day of its closure on 26 August 2014. The financial problem was generated in the media industry for the abundance of free information available on the Internet, worldwide phenomenon that has affected many newspapers, the newspaper had in its circulation decline, which led it to close its activities in 2014 (Torres Rodriguez, 2013).

The Internet was the main problem for this company went bankrupt (Canals, 2001). Due to globalization, companies must accommodate with innovations but if they do not do that, they will not be able to compete with companies that accommodate easily with innovation. That is exactly what happened to the Journal HOY. Even if HOY is not a contemporary company, they had a contemporary problem, which sparked a financial chaos.

The Superintendence of Companies of Ecuador reported in 2014 the dissolution of more than 700 companies, among which is Edimpres, which was in charge to prints HOY's newspaper, by backslide for two years in losses of 50% or more of the capital, but for years the situation of the company was problematic, as agreed authorities and employees (Superintendencia de Compañía, 2014). According to the Superintendence (2014), the dissolved companies did not submit releases that could show that remedied the grounds for dissolution. Instead, the company committee HOY has 154 workers who, according to its agent, HOY owed two months' salary (July and August) and the fourteenth salary (an extra minimum wage of $340 to cover expenses for the start of the school).

According to research by The Andes, HOY came generating losses as a company for 15 years (eight years before the current government and 14 years before the term of the Communications Law), according to the Superintendence of Companies (ANDES, 2014). Besides, its low circulation ceased to be attractive long for advertising companies. Economic losses of HOY (Edimpres) reached 63% of its assets in 2013, which is a violation of the Companies Act, which requires that the accumulated losses do not exceed 50%, said the regional director of Control, Inspection, Audit and Intervention of the Superintendence of Companies, Azucena Palacios.

According to the statements of financial position found on the website of control, an entity concludes that in the last 15 years operations daily were now negative, as the company only made a profit in 2004, 2005 and 2006. This clarifies that the closure of rotary issues related to the Communications Law (effective June 2013), but with permanent periodic financial problems should not be. The rotary Jaime Mantilla, one of the 209 registered print media in the Andean country, according to the Council Regulation and Development of Information and Communication (Cordicom) always showed negative figures on their balance sheets and financial problems. In 2014, the company had to notify four glosses for late payment of $132 each employer's liability rightly that might include medical care, pensions or actions irrigation work to the Ecuadorian Institute of Social Security,

In addition, from January 2012 to February 2014, the Ministry of Labor received 41 complaints against Edimpres, including cases, consist of pensions, salaries and wages evictions. Because of these complaints, the ministry of State determined a fine of $ 150.530; a process is in the stage of coercive. The Superintendent of Companies, Suad Mansour said in the Twitter "By law the @SuperciasEC dissolved companies. It does not distinguish whether it is a media, a pharmaceutical, real estate, or whatever." He adds that once the dissolution notified, no company can operate because the Companies Act is for everyone" (Superintendencia de Compañía, 2014).

According to Article 361 of the Act, the loss of 50% or more of the capital is one of the grounds for dissolution of companies. In this case, they had to close their door to the employees and work online in Ecuador.

Conclusions and implications

The data shows that the banking system is solid and liquidity, but it is taking to preserve liquidity forecasts in a difficult year. The decrease of deposits is making banks more cautious when to provide credits. The restriction is reflected in higher requirements for customers, longer times in approval and disbursements and the demand for more guarantees.

Another point very relevant, the banks should set a liquidity margin, including the creation of liquid assets that are used in stressful situations. The financial institution must determine costs, benefits and liquidity risks of its activities. In addition, stress scenarios should design and develop a contingency plan operational. Then, financial institutions must be solvent and solid, in which, the funds required by companies are very useful and allow them to minimize the risk and face the uncertainty of the future. Is for that reason, that we have presented in this paper some principles to liquidity risk management and how Ecuadorian financial institutions manage their credit risk.

Contemporary companies can take steps to minimize the risk; however, this is not released. They can apply various techniques such as financial innovations, sensitivity analysis, cash budget, analysis of projections, among others.

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