
**Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation**

Subject: **Country Risk**

Description: **Sound Risk Management
Practices**

Purpose

This interagency statement describes the elements of an effective country risk management process. These principles will guide examiners when they evaluate the management of country risk in internationally active U.S. banks, bank holding companies, and their affiliates.

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Background

Along with the risks present in their domestic operations, institutions engaged in international activities are exposed to “country risk” — the risk that economic, social, and political conditions and events in a foreign country will adversely affect an institution’s financial interests. In addition to the adverse effect that deteriorating economic conditions and political and social unrest may have on the rate of default by obligors in a country, country risk includes the possibility of nationalization or expropriation of assets, government repudiation of external indebtedness, exchange controls,¹ and currency depreciation or devaluation.

¹ Exchange controls are an example of transfer risk, which is a facet of country risk. Transfer risk is the possibility that an asset cannot be serviced in the currency of payment because the obligor’s country lacks the necessary foreign exchange or has put restraints on its availability. The Interagency Country Exposure Review Committee (ICERC) assigns ratings to foreign exposures based on its evaluation of the level of transfer risk associated with a country. See the *Guide to the Interagency Country Exposure Review Committee Process*, which was issued in November 1999, for a comprehensive discussion of the operations of the ICERC.

Country risk has an overarching effect on an institution's international activities and should explicitly be taken into account in the risk assessment of all exposures (including off-balance-sheet) to all public- and private-sector foreign-domiciled counterparties. The risk associated with even the strongest counterparties in a country will increase if, for example, political or macroeconomic conditions cause the exchange rate to depreciate and the cost of servicing external debt to rise.

Country risk is not necessarily limited to an institution's exposures to foreign-domiciled counterparties. Although it may not be feasible to incorporate the potential effect of country risk on domestic counterparties into an institution's formal country risk management process, country risk factors should nevertheless be taken into account, where appropriate, when assessing the creditworthiness of domestic counterparties. Country risk would be pertinent to exposures to U.S.-domiciled counterparties if the creditworthiness of the borrower or of a guarantor (or the value of the collateral) is significantly affected by events in a foreign country. For example, a domestic borrower's credit risk might increase because of significant export receivables from a foreign country or because of the transfer-pricing of imports from a foreign affiliate. Country risk considerations would also be pertinent when one of the determinants of a transaction's value is a foreign country's foreign exchange or interest rate environment, as would be the case in an interest rate swap in which one rate is derived from a foreign country's yield curve.

Country risk is not limited solely to credit transactions. Investments in foreign subsidiaries, electronic banking agreements, and EDP servicing and other outsourcing arrangements with foreign providers all carry with them the risk that policies or conditions in a foreign country may have adverse consequences for the institution.

Elements of an Effective Country Risk Management Process

To effectively control the risk associated with international activities, institutions must have a risk management process that focuses on the broadly defined concept of country risk. A sound country risk management process includes:

- Effective oversight by the board of directors,
- Adequate risk management policies and procedures,
- An accurate system for reporting country exposures,
- An effective process for analyzing country risk,
- A country risk rating system,
- Established country exposure limits,
- Regular monitoring of country conditions,
- Periodic stress testing of foreign exposures, and

- Adequate internal controls and audit function.

Although the details and complexity of the country risk management process will vary from one institution to the next, such management must be commensurate with the volume and complexity of the institution's international activities. Supervisory expectations will also take into consideration the institution's size and technological capabilities.

Oversight by the Board of Directors

If country risk is to be managed properly, the board of directors must oversee the process effectively. The board is responsible for periodically reviewing and approving policies governing the institution's international activities to ensure that they are consistent with the institution's strategic plans and goals. The board is also responsible for reviewing and approving limits on country exposure and ensuring that management is effectively controlling the risk. When evaluating the adequacy of the institution's capital and allowance for loan and lease losses (ALLL), the board should take into account the volume of foreign exposures and the ratings of the countries to which the institution is exposed.

Policies and Procedures for Managing Country Risk

Bank management is responsible for implementing sound, well-defined policies and procedures for managing country risk that:

- Establish risk tolerance limits;
- Delineate clear lines of responsibility and accountability for country risk management decisions;
- Specify authorized activities, investments and instruments; and
- Identify both desirable and undesirable types of business.

Management should also ensure that country risk management policies, standards and practices are clearly communicated to the affected offices and staff.

Country Exposure Reporting System

To effectively manage country risk, the institution must have a reliable system for capturing and categorizing the volume and nature of foreign exposures. The reporting system should cover all aspects of the institution's operations, whether conducted through paper transactions or electronically. An accurate country exposure reporting system is also necessary to support the regulatory reporting of foreign exposures on the quarterly FFIEC 009 Country Exposure Report.

The board of directors should regularly receive reports on the level of foreign exposures. If the level of foreign exposures in an institution is significant,² or if a country to which the institution is exposed is considered to be high risk, exposures should be reported to the board at least quarterly. More frequent reporting is appropriate when a deterioration in foreign exposures would threaten the soundness of the institution.

Country Risk Analysis Process

Although the nature of the country risk analysis process and the level of resources devoted to it will vary from institution to institution, depending on the size and sophistication of its international operations, a number of considerations are relevant to evaluating the process in all institutions:

- Is there a quantitative and qualitative assessment of the risk associated with each country in which the institution is conducting or planning to conduct business?
- Is a formal analysis of country risk conducted at least annually, and does the institution have an effective system for monitoring developments in the interim?
- Does the analysis take into account all aspects of the broadly defined concept of country risk, as well as any unique risks associated with specific groups of counterparties the institution may have targeted in its business strategy?
- Is the analysis adequately documented, and are conclusions concerning the level of risk communicated in a way that provides decision makers with a reasonable basis for determining the nature and level of the institution's exposures in a country?
- Given the size and sophistication of the institution's international activities, are the resources devoted to the analysis of country risk adequate?
- As a final check of the process, are the institution's conclusions concerning a country reasonable in light of information available from other sources, including external research and rating services and the Interagency Country Exposure Review Committee (ICERC)?

Conclusions about the level of country risk reflect an evaluation of the effect of prevailing (and possible future) economic, political and social conditions on a country's ability to sustain external debt service, as well as the impact of these conditions on the credit risk of individual counterparties located in the country. The annex to this statement provides a more detailed description of these factors.

Country Risk Ratings

Country risk ratings summarize the conclusions of the country risk analysis process. The ratings are an important component of country risk management because they provide a

² For purposes of this guidance, concentrations of exposures to individual countries that exceed 25 percent of the institution's Tier 1 capital plus the ALLL are considered significant; however, in the case of particularly troubled countries, lesser degrees of exposure may also be considered to be significant.

framework for establishing country exposure limits that reflect the institution's tolerance for risk.

Because some counterparties may be more exposed to local country conditions than others, it is a common and acceptable practice for institutions to distinguish between different types of exposures when assigning their country risk ratings. For example, trade-related and banking sector exposures typically receive better risk ratings than other categories of exposure because the importance of these types of transactions to a country's economy has usually moved governments to give them preferential treatment for repayment.

The risk rating systems of some institutions differentiate between public sector and private-sector exposures. And in some institutions, a country's private sector credits cannot be rated less severely than its public sector credits (*i.e.*, the institution imposes a "sovereign ceiling" on the rating for all exposures in a country). Both are acceptable practices.

An institution's country risk ratings may differ from the ICERC-assigned transfer risk ratings because the two ratings differ in purpose and scope. An institution's internally assigned ratings help it to decide whether to extend additional credit, as well as how to manage existing exposures. Such ratings should, therefore, have a forward-looking and broad country risk focus. The ICERC's more narrowly focused transfer risk ratings are primarily a supervisory tool to identify countries where concentrations of transfer risk might warrant greater scrutiny and to determine whether some minimum level of reserves against transfer risk should be established.

Country Exposure Limits

As part of their country risk management process, internationally active institutions should adopt a system of country exposure limits. Because the limit-setting process often involves divergent interests within the institution (such as the country managers, the institution's overall country risk manager, and the country risk committee), country risk limits will usually reflect a balancing of several considerations, including:

- The overall strategy guiding the institution's international activities;
- The country's risk rating and the institution's appetite for risk;
- Perceived business opportunities in the country; and
- The desire to support the international business needs of domestic customers.

Country exposure limits should be approved by the board of directors, or a committee thereof, and communicated to all affected departments and staff. Exposure limits should be reviewed and approved at least annually — more frequently when concerns about a particular country arise.

An institution should consider whether its international operations are such that it should supplement its aggregate exposure limits with more discrete controls. Such controls

might take the form of limits on the different lines of business in the country, limits by type of counterparty, or limits by type or tenor of exposure. An institution might also limit its exposure to local currencies. Institutions that have both substantial capital market exposures and credit-related exposures typically set separate aggregate exposure limits for each because exposures to the two lines of business are usually measured differently.

Although country-by-country exposure limits are customary, institutions should also consider limiting (or at least monitoring) exposures on a broader (*e.g.*, regional) basis. A troubled country's problems often affect its neighbors, and the adverse effects may also extend to geographically distant countries with close ties through trade or investment. By monitoring and controlling exposures on a regional basis, institutions are in a better position to respond if the adverse effects of a country's problems begin to spread.

For institutions that are engaged primarily in direct lending activities, monthly monitoring of compliance with country exposure limits is adequate. However, institutions with more volatile portfolios, including those with significant trading accounts, should monitor compliance with approved limits more frequently. Exceptions to approved country exposure limits should be reported to an appropriate level of management or the board so that it can consider corrective measures.

Monitoring Country Conditions

The institution should have a system in place to monitor current conditions in each of the countries where it is significantly exposed. The level of resources devoted to monitoring conditions within a country should be proportionate to the institution's level of exposure and the perceived level of risk. If the institution maintains an in-country office, reports from the local staff are an obviously valuable resource for monitoring country conditions. In addition, periodic country visits by the regional or country manager are important to properly monitor individual exposures and conditions in a country. The institution may also draw on information from rating agencies and other external sources.

There should also be regular, on-going communication between senior management and the responsible country managers. The institution should not rely solely on informal lines of communication and *ad hoc* decision-making in times of crisis. Established procedures should be in place for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country.

Stress Testing

Institutions should periodically stress-test their foreign exposures and report the results to the board of directors and senior management. As used here, stress testing does not necessarily refer to the use of sophisticated financial modeling tools, but rather to the need for all institutions to evaluate in some way the potential impact of different scenarios on their country risk profiles. The level of resources devoted to this effort should be commensurate with the significance of foreign exposures in the institution's overall operations.

Internal Controls and Audit

Institutions should ensure that their country risk management process includes adequate internal controls, and that there is an audit mechanism to ensure the integrity of the information used by senior management and the board to monitor compliance with country risk policies and exposure limits. The system of internal controls should, for example, ensure that responsibilities of marketing and lending personnel are properly segregated from the responsibilities of personnel who analyze country risk, rate country risk, and set country limits.

Contacts

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ANNEX

Factors Affecting Country Risk

The debt crises experienced by a number of lesser-developed and emerging market countries over the past 20 years have focused attention on a number of factors that are particularly relevant to the analysis of country risk.

Macroeconomic Factors

The first of these factors is the size and structure of the country's external debt in relation to its economy. More specifically:

- The current level of short-term debt and the potential effect that a liquidity crisis would have on the ability of otherwise creditworthy borrowers in the country to continue servicing their obligations.
- To the extent the external debt is owed by the public sector, the ability of the government to generate sufficient revenues, from taxes and other sources, to service its obligations.

The condition and vulnerability of the country's current account is also an important consideration, including:

- The level of international reserves, including forward market positions of the country's monetary authority (especially when the exchange rate is fixed).
- The level of import coverage provided by the country's international reserves.
- The importance of commodity exports as a source of revenue, the existence of any price stabilization mechanisms, and the country's vulnerability to a downturn in either its export markets or the price of an exported commodity.
- The potential for sharp movements in exchange rates and the effect on the relative price of the country's imports and exports.

The role of foreign sources of capital in meeting the country's financing needs is another important consideration in the analysis of country risk, including:

- The country's access to international financial markets and the potential effects of a loss of market liquidity.
- The country's relationships with private sector creditors, including the existence of loan commitments and the attitude among bankers toward further lending to borrowers in the country.

- The country's current standing with multilateral and official creditors, including the ability of the country to qualify for and sustain an International Monetary Fund or other suitable economic adjustment program.
- The trend in foreign investments and the country's ability to attract foreign investment in the future.
- The opportunities for privatization of government-owned entities.

Past experience has highlighted the importance of a number of other important macroeconomic considerations, including:

- The degree to which the economy of the country may be adversely affected through the contagion of problems in other countries.
- The size and condition of the country's banking system, including the adequacy of the country's system for bank supervision and any potential burden of contingent liabilities that a weak banking system might place on the government.
- The extent to which state-directed lending or other government intervention may have adversely affected the soundness of the country's banking system, or the structure and competitiveness of the favored industries or companies.
- For both in-country and cross-border exposures, the degree to which macroeconomic conditions and trends may have adversely affected the credit risk associated with counterparties in the country.

Social, Political and Legal Climate

The analysis of country risk should also take into consideration the country's social, political and legal climate, including:

- The country's natural and human resource potential.
- The willingness and ability of the government to recognize economic or budgetary problems and implement appropriate remedial action.
- The degree to which political or regional factionalism or armed conflicts are adversely affecting government of the country.
- Any trends toward government-imposed price, interest rate, or exchange controls.
- The degree to which the country's legal system can be relied upon to fairly protect the interests of foreign creditors and investors.
- The accounting standards in the country and the reliability and transparency of financial information.

- The extent to which the country's laws and government policies protect parties in electronic transactions and promote the development of technology in a safe and sound manner.
- The extent to which government policies promote the effective management of the institution's exposures.
- The level of adherence to international legal and business practice standards.

Institution-Specific Factors

Finally, an institution's analysis of country risk should take into consideration factors relating to the nature of its actual (or approved) exposures in the country including, for example:

- The institution's business strategy and its exposure management plans for the country.
- The mix of exposures and commitments, including the types of investments and borrowers, the distribution of maturities, the types and quality of collateral, the existence of guarantees, whether exposures are held for trading or investment, and any other distinguishing characteristics of the portfolio.
- The economic outlook for any specifically targeted industries within the country.
- The degree to which political or economic developments in a country are likely to affect the institution's chosen lines of business in the country. For instance, the unemployment rate or changes in local bankruptcy laws may affect certain activities more than others.
- For an institution involved in capital markets, its susceptibility to changes in value based on market movements. As the market value of claims against a foreign counterparty rise, the counterparty may become less financially sound, thus increasing the risk of non-payment. This is especially true with regard to over-the-counter derivative instruments.
- The degree to which political or economic developments are likely to affect the credit risk of individual counterparties in the country. For example, foreign counterparties with healthy export markets or whose business is tied closely to supplying manufacturing entities in developed countries may have significantly less exposure to the local country's economic disruptions than do other counterparties in the country.
- The institution's ability to effectively manage its exposures in a country through in-country or regional representation, or by some other arrangement that ensures the timely reporting of, and response to, any problems.