Country Risk Management

Background

Country Risk refers to the possibility that economic and political conditions, or an event in a foreign country, could adversely impact an institution's exposure in that country. The institutions engaged in international lending or having other cross border exposure are exposed to country risk, in addition to the customary credit risk.

Country risk is not limited solely to an institution's international lending operations, rather their other on balance sheet activities such as overseas investments, placements etc as well as off balance sheet exposures such as letters of credit, guarantees/bonds, foreign exchange contracts etc., contain country risk. Besides, an institution's outsourcing arrangements such as electronic data processing, electronic banking or any consultancy/management services, with overseas counter parties, also carry inherent country risk.

While institutions are indirectly exposed to country risk as a result of their exposure to domestic entities that have significant cross border exposures[♣], these institutions are not required to take into account such exposures in their formal country risk management process. However, such indirect country risk assessment pertains to credit risk management and banks are expected to give due consideration to this aspect while taking an exposure on such domestic entities.

Institutions can exercise little direct influence on the country risk they are exposed to. This distinctive nature of country risk necessitates that banks having significant cross border risk exposure should have adequate country risk management framework.

Types of Country Risk

Country risk can be broadly classified into sovereign, transfer/convertibility and contagion risk.

Sovereign risk denotes a foreign government's capacity and willingness to repay its direct and indirect (i.e. guaranteed) foreign currency obligations.

Transfer/Convertibility risk arises if changes in government policies, or any event, result in a barrier to free conversion or movement of foreign exchange across countries. Under such conditions, a borrower may not be able to secure foreign exchange to service its external obligations. Where a country suffers economic or political problems, leading to depletion of its foreign currency reserves, the borrowers in that country may not be able to convert their funds from local currency into foreign currency to repay their external obligations.

Contagion risk refers to the possibility that any adverse economic or political factor in one country has an impact on other countries in that region.

Elements of Country Risk Management

Board and Senior Management oversight

It is the responsibility of the board to define the level of country risk the institution can undertake and to ensure that the institution has country risk management

[♣] For instance, loan to an exporter who has significant foreign currency receivables.

framework consistent with the level of institution's cross border exposure. Towards this end, the board should ensure that there are well-defined policies and procedures for country risk management. Similarly, the senior management should ensure that the staff entrusted with the responsibility is capable of dealing with it and the managerial structure and resources devoted for country risk management are commensurate with the level of the institution's overseas exposure.

Policies and procedures

Institutions (having significant cross border exposure) should have written policies and procedures for their country risk management. Generally, such policies/ procedures encompass following aspects.

- Delineate clear lines of responsibility and accountability for country risk management decisions.
- Set up an internal rating system or use external ratings (if the bank has little cross border exposure and it is not feasible to institute an internal country risk rating mechanism).
- Establish risk tolerance limits.
- Specify authorized activities and instruments.
- Set up a mechanism to monitor and report the institutions' country exposure for senior management and BOD's review.

To be effective, these polices should be communicated down the line to the concerned offices and staff. The policies should be approved by the board and subject to review semi-annually or more frequently, if the need arises.

Country Risk Assessment

SBP is aware that a number of banks may not have the capacity, or it is not feasible for them, given the level of their cross border exposure, to have internal country risk assessment mechanism. These institutions, as an alternate, may rely on external country ratings and supplement them with other sources of market research on country risk.

Economics or research units in each major institution having significant cross-border and foreign exposure should be entrusted with preparing assessments of the country risk of the countries in which the institution is involved. The analysis, process and the level of resources devoted to it will depend upon the size of foreign exposure. However, the institutions may take the following into account:

- A formal country risk analysis is conducted at least semi-annually for every country on which the bank has a significant level of exposure (the significant level can be decided by the BOD).
- The analysis is properly documented and conclusions are reported in a way that provides the decision makers with a reasonable basis for determining the nature and level of the institution's exposure in a country.
- The analysis should cover all exposures and take into account all aspects of broadly defined concepts of country risk.

Country Risk Rating

Country Risk ratings summarize the conclusion of the risk analysis process. Ratings are important as they provide a framework for establishing exposure limits. As stated earlier, institutions are given a choice either to use external ratings or establish their own country risk ratings framework. The institutions that have significant cross border exposure; greater analytical resources and access to better information may opt for the later. These institutions should consider external rating as an input for their internal ratings. Ratings should be reviewed semi-annually or more frequently if the situation warrants.

Country Risk Limits

Institutions having sophisticated risk management system for their country risk analysis may have little influence on the country risk inherent in their cross border exposures. Nevertheless, institutions can minimize the possible losses by diversifying their exposures outside the country. An appropriate way to do this is to set country exposure limits. The institutions may consider the following while setting their country exposure limits.

- The limits should be set on prudential basis rather than purely on business/ commercial basis.
- Since different product lines or activities in the same country carry different levels of risk, it is appropriate to support aggregate country exposure limit with more discrete controls. Such controls might take the form of sub limits on the basis of business lines, types of obligors or tenor etc.
- There may be separate limits for total country exposure, as well as foreign currency country exposure[♣].

Limits should be periodically reviewed to incorporate changing scenarios. Finally, once the limits are set, they should not be breached without going through a procedure for approval from a designated approving authority as identified by the board or policy-making group, which actually approved the policy and the said limits. The institutions should establish a mechanism of monitoring compliance with these limits. Any breach of limits should be reported to the senior management who should take appropriate corrective action.

Management Information system

Country exposure should be continuously monitored and reported to the appropriate authority. Institutions should have an effective system in place to generate management reports which are detailed enough to permit analysis of different types of risk and cover all aspects of institution's operations. The reports should also identify the exceptions in a timely manner. Institutions should consider not only outstanding exposures but also un-drawn commitments as well.

Internal Control and Audit

Country risk management process should have an adequate internal control mechanism. To achieve objectivity, the responsibility of marketing and lending personnel should be segregated from responsibilities of personnel who analyze country risk, assign country risk ratings and set limits structure.

The internal audit function, in addition to review of compliance with policies /procedures, should ensure the integrity of the reports/information prepared for senior management.

[♣] Total country exposure encompasses both exposure in the local currency of that particular country and exposure emanating from that country in third currencies, whereas foreign currency exposure excludes local currency exposure.