
SUPERVISORY AND REGULATORY GUIDELINES: 2006-0
Country Risk Management
11th April, 2006

**GUIDELINES FOR THE
MANAGEMENT OF COUNTRY RISK**

I. INTRODUCTION

The Central Bank of The Bahamas (*“the Central Bank”*) is responsible for the licensing, regulation and supervision of banks and trust companies operating in and from within The Bahamas pursuant to The Banks and Trust Companies Regulation Act, 2000 and The Central Bank of The Bahamas Act, 2000. Additionally, the Central Bank has the duty, in collaboration with financial institutions, to promote and maintain high standards of conduct and management in the provision of banking and trust services.

All licensees are expected to adhere to the Central Bank’s licensing and prudential requirements, ongoing supervisory programmes and regulatory reporting requirements, and are subject to periodic onsite inspections. Licensees are expected to conduct their affairs in conformity with all other Bahamian legal requirements.

II. PURPOSE

Country risk is the risk that economic, social, and political conditions and events in a foreign country will adversely affect a licensee’s financial condition. In addition to the negative effect that deteriorating economic conditions and political and social unrest may have on the rate of default by obligors in a country, country risk also includes the possibility of nationalization or expropriation of assets, government repudiation of external indebtedness, sudden changes in exchange control policies, and currency depreciation or devaluation.

Because the Central Bank supervises institutions that are based in over thirty countries, many of our licensees engage in international lending and incur cross border exposures that leave them open to country risk. The Central Bank is of the view that sound country risk management should be a part of the risk management framework of any licensee that engages in international activities.

The aim of this Guideline is to assist licensees in establishing internal structures, policies, and procedures for the sound management of country risk.

III. APPLICABILITY

These Guidelines apply, as appropriate, to all licensees that engage in business activities which produce country risk. Licensees with significant international exposures will be directly affected by country risk and should pay particular attention to these Guidelines. Licensees with exposures to domestic-based counterparties may be indirectly affected by country risk if the creditworthiness of a borrower or guarantor (or the value of the collateral) is considerably affected by events in a foreign country. Although it may not be feasible for licensees to formally incorporate the potential effect of country risk on domestic counterparties into its official country risk management process, country risk factors should nevertheless be taken into account, where appropriate, when assessing the creditworthiness of domestic counterparties.

These Guidelines are not intended to be overly prescriptive and should be tailored, as appropriate, to the level and complexity of licensees' exposures to country risk. In addition to the minimum requirements outlined in these Guidelines, licensees are encouraged to introduce industry "best practice" policies and procedures. The licensee's risk management strategies, policies, and the degree of detail incorporated into internal directives should be commensurate with the volume and type of exposure.

In the case of branches of foreign banks, the Central Bank accepts that country risk management will usually be undertaken by their head offices on a group basis. Where the Central Bank is not satisfied that the Bahamian branch's exposures are adequately managed, it reserves the right to require measures to be taken by the licensee concerned to make up for any deficiencies.

IV. SUPERVISORY APPROACH

Principle 11 of the Basel Committee's "*Core Principles for Effective Banking Supervision*", states that,

Banking supervisors should be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investments activities and for maintaining appropriate reserves against such risks.

The Central Bank encourages its licensees to effectively manage country risk and will review their management strategies and the adequacy of the provisions made. Specifically, it will seek to determine that there is:-

- 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;
- regular monitoring of country conditions;
- periodic stress testing of international exposures; and
- adequate internal controls and audit function.

The Central Bank will consider the size and complexity of a licensee's cross border business and other factors set out in these Guidelines in considering whether the licensee has appropriate systems to control country risk and maintains adequate provisions for such risk.

The Central Bank will conduct regular reviews of the level of country risk provisions made by individual licensees. It may, on a case by case basis, require licensees to re-assess their country risk provisions if there are grounds to doubt whether their existing provisioning levels is adequate.

V. TYPES OF COUNTRY RISK

Unlike other forms of risk, licensees can exercise little direct influence over country risk. As such they should familiarize themselves with the types of country risk to which they may be exposed and tailor their risk management framework accordingly. Licensees should ensure that they have adequate systems and expertise to manage their international exposures and avoid taking undue concentration risks on such exposures.

There are six main types of country risk:-

1. **Sovereign Risk.** A foreign government's ability and willingness to repay its direct and guaranteed foreign currency obligations;
2. **Transfer Risk.** The risk that a borrower may not be able to secure foreign exchange to service its external debt due to drainage in the country's foreign currency reserves;
3. **Contagion Risk.** Adverse developments in one country leads to a ratings downgrade or a credit squeeze for other countries in the region, notwithstanding that those countries may be more creditworthy and that the adverse developments do not apply to them;

4. **Currency Risk.** The risk that a borrower's domestic currency holdings and cash flow become inadequate to service its foreign currency obligations because of devaluation;
5. **Macroeconomic Risk.** The risk that the borrower in a country may, for example, suffer from the impact of high interest rates due to measures taken by the government of that country to defend its currency. Governments may also decide to nationalize or expropriate foreign assets; and
6. **Indirect Country Risk.** The risk that a domestic borrower's ability to repay a loan is compromised by the deterioration of the economic, social, or political conditions in a foreign country where the borrower has substantial business interests.

VI. EFFECTIVE COUNTRY RISK MANAGEMENT PROCESS

To effectively control the risk associated with international activities, licensees must have a risk management process that focuses on the broadly defined concept of country risk. A sound country risk management process should at a minimum, address the following:-

1. Oversight by the Board of Directors and Senior Management

The Board of Directors¹ ("the Board") is responsible for periodically reviewing and approving policies and governing the licensee's international activities to ensure that they are consistent with the licensee's existing risk framework and overall strategic plans and goals. The Board is also responsible for reviewing and approving limits on country exposures and ensuring that management is effectively controlling the risk. When evaluating the adequacy of the licensee's capital and provisions, the board should take into account the volume of foreign exposures and the ratings of the countries to which the institution is exposed. Furthermore, the Board should ensure that the licensee adheres to these Guidelines.

2. Risk Management Policies

The licensee's senior management is responsible for implementing sound, well-defined country risk management policies and procedures that:-

- (a) establish risk tolerance limits, including the overall limits and sub-limits for cross border exposures;
- (b) delineate clear lines of responsibility and accountability for country risk management decisions, including approval of cross border lending and exceptions;

¹ In the case of branches, the management at the head office responsible for the operations of the Bahamian branch.

- (c) outline the standards and criteria to be used to analyze the risk of particular countries and the internal country rating system, if any, or how the country risk elements are factored into the licensee's existing loan classification system;
- (d) specify authorized activities, investments and instruments; and
- (e) 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.

3. Country Risk Analysis Process

Although the nature of the country risk analysis process and the level of resources devoted to it will vary from licensee to licensee, depending on the size and sophistication of its international operations, when evaluating country risk analysis, the following questions should be considered:-

- (a) Is there a quantitative and qualitative assessment of the risk associated with each country in which the licensee is conducting or planning to conduct business?
- (b) Is a formal analysis of country risk conducted at least annually, and does the licensee have an effective system for monitoring developments in the interim?
- (c) 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 licensee may have targeted in its business strategy?
- (d) 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 licensee's exposures in a country? and
- (e) Given the size and sophistication of the licensee's international activities, are the resources devoted to the analysis of country risk adequate?

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.

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

for risk. A licensee'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.

As some counterparties may be more exposed to local country conditions than others, it is a common and acceptable practice for licensees 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 have usually moved governments to give them preferential treatment for repayment.

The risk rating systems of some licensees may differentiate between public sector and private-sector exposures. Further, for some licensees, 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.

5. Country Exposure Limits

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

- (a) the overall strategy guiding the institution's international activities;
- (b) the country's risk rating and the institution's appetite for risk;
- (c) perceived business opportunities in the country; and
- (d) the desire to support the international business needs of domestic customers.

Country exposure limits should be approved by the Board, 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.

A licensee should consider whether its international operations are such that it should supplement its aggregate exposure limits with more discrete controls such as limits on the different lines of business in the country, limits by type of counterparty, or limits by type or tenor of exposure. A licensee might also limit its exposure to local currencies. Licensees 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, licensees should also consider limiting (or at least monitoring) exposures on a broader (*e.g.*, regional) basis in an effort to minimize the effects of contagion risk. 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 licensees that are engaged primarily in direct lending activities, monthly monitoring of compliance with country exposure limits is adequate. However, licensees 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.

6. Monitoring Country Conditions

Each licensee must be in a position to identify country risk exposure by monitoring conditions in countries to which they are exposed. They should watch the performance of these positions and report findings to the Board.

Licensees should have a system in place to monitor current conditions in each of the countries where they are 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 licensee 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 licensee 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 licensee 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.

7. Country Risk Reporting

Licensees 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 licensee's operations, whether conducted through paper transactions or electronically.

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

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

the licensee is exposed is considered to be high risk, exposures should be reported to the board at least quarterly. More frequent reporting is appropriate when deterioration in foreign exposures would threaten the licensee's financial soundness.

8. Stress Testing

Licensees 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 licensees 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 licensee's overall operations.

9. Internal Controls and Audit

Licensees 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 and rate country risk, and set country limits.

VII. COUNTRY RISK PROVISIONING

Country risk provisions are set aside to absorb potential losses arising from exposure to country risk. Licensees may decide to assign provisions by either:-

- (a) reflecting country risk provisions earmarked against their aggregate exposure to a particular country after accounting for risk transfer and specific provision made against credit risk (i.e. on a country basis); or
- (b) factoring in an element of provision for country risk into specific provisioning for each individual exposure (i.e. on an individual obligor basis).

Regardless of the approach licensees adopt, they should make sure that they have adequate country risk provisions for their assessment of the probability of losses arising from their cross-border exposures.

Licensees may not, however, need to make additional provisions solely for country risk if they are satisfied that the current level of specific and general provisions is already sufficient to absorb any potential losses due to both credit and country risks. In light of this, it is important that the risk management policy specify criteria for when to provide

and how to calculate country risk provisions. It should clearly indicate which party has the authority to decide the level of country risk provision.

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