COUNTRY RISK MANAGEMENT GUIDELINE

1. INTRODUCTION

The Central Bank of Barbados (Bank), in furtherance of its responsibility for the regulation and supervision of licensees under the Financial Institutions Act 1996-16 and the International Financial Services Act 2002-5, has developed this Guideline to provide guidance to licensees on their obligations as it relates to the management of country risk.

Country risk refers to the possible risk that a licensee's financial condition would be adversely affected due to country specific conditions that prevent foreign borrowers from meeting their contractual obligations. These country-specific conditions may result from economic, social political or natural events and may relate to factors such as exchange controls, currency devaluations, nationalization or expropriation of assets among others.

Licensees that engage in international lending and investing are, in addition to credit risk, exposed to country risk with respect to their cross border exposures. Domestic borrowers who rely for a significant part of their business on foreign counterparties may also face country risk. Investments in branches and/or foreign subsidiaries and outsourcing arrangements with foreign service providers also carry country risk. Licensees must therefore be aware of the different types of country risks to which they are exposed and implement a sound country risk management program to mitigate this risk. Some of the sources of country risk are defined in Appendix 1.

The Guideline sets out the Bank's expectations in relation to the minimum policies that each licensee should have in place as it relates to its country risk management. These policies should take into account the size and nature of the licensee's cross border activities and should be read in conjunction with the Credit Risk Management Guideline.

2. APPLICATION

This Guideline applies to all entities licensed under the Financial Institutions Act 1996-16 and the International Financial Services Act 2002-5. The Bank recognises that country risk exposure varies among licensees and it is expected that licensees will implement a program that is commensurate with the size, nature and complexity of their cross-border activities.

In the case of branches of foreign banks, it is recognised that their head offices may undertake the overall country risk management of the group. However, it is expected that licensees will put in place measures to ensure that branch exposures are adequately managed.

3. BOARD OF DIRECTORS AND SENIOR MANAGEMENT

The primary responsibility for establishing adequate country risk management systems and determining the appropriate level of country risk provision rests with the Board of Directors and senior management of the licensee.

3.1 Board of Directors

The Board is ultimately responsible for establishing adequate country risk management systems. The Board needs to ensure that the country risk policy developed by management adequately provides for processes and procedures to identify, measure, monitor and control the licensee's country risk exposure. The assessment and measurement of country risk allows the licensee to measure potential losses stemming from country and transfer risk, determine the appropriate level of provisioning and assess the adequacy of its capital.

To this end, the Board should at a minimum:

a. Review and approve country risk management and provisioning policies and procedures;
b. Review and approve country limits in relation to regulatory capital. Limits should be reviewed at least annually or in relation to the volatility of the credit worthiness of foreign counterparties stemming from their country specific conditions;
c. Review and assess country risk reports to ensure that exposures are managed prudently in accordance with the internal policy and that corrective actions are taken for breaches identified; and
d. Ensure that there is an independent review/audit of the country risk management process.

3.2 Senior Management

Senior management is responsible for the development and implementation of the country risk management policy. In carrying out its responsibilities, management should ensure that the country risk management program takes into account the licensee's foreign country business strategy, the parameters under which such business is carried out, as well as its risk appetite and risk tolerances. Management should ensure that such lending meets traditional lending criteria. In addition, management should at a minimum:

a. Develop appropriate country risk management and provisioning policies for approval by the Board. These policies should include limits and sub-limits for cross border exposures;
b. Establish clear lines of authority, responsibility and accountability;

c. Identify the types of country risk which may be incurred by the licensee and the processes and procedures to manage them;
d. Identify the types of and criteria for acceptable collateral and guarantees, financial instruments etc. which can be used for the mitigation of country risk and the requirements for the perfection of collateral;
e. Establish the minimum standard terms and conditions to be incorporated in loan documentation in accordance with the legal requirements of each country;
f. Establish the criteria which will be used to assess the risk of foreign countries;
g. Develop an internal country risk rating system or develop a process by which country risk can be incorporated into the loan classification system. Some licensees may consider using international assessments to help them make their own assessment;
h. Develop and implement methods to adequately measure country risk exposures;
i. Conduct stress-testing exercises to evaluate the impact of country risk exposures on capital and profitability;
j. Establish procedures for dealing with deteriorating conditions in foreign country with clear contingency plans and exit strategies; and
k. Provide comprehensive management reports on the licensee's country risk exposures to the Board.

4. COUNTRY RISK MANAGEMENT

Although the particulars of the country risk management program will differ among licensees, depending upon the nature and complexity of the licensee's international activities, a comprehensive country risk management program should entail:

a. An adequate country risk assessment process;
b. Techniques to identify and measure country risk exposures;
c. Appropriate and effective monitoring and control procedures; and
d. Stress testing and contingency planning.

4.1 Country Risk Assessment

The assessment of country risk is an essential part of the process of managing a licensee's international lending and investment portfolios. Country risk assessment refers to the methodology used by licensees to evaluate the risk of an interruption or default in the servicing or repayment of obligations by borrowers of a particular country.

Country risk assessment should consider both quantitative and qualitative data and enable the licensee to determine whether there will be impediments to the repayment of foreign debt. In developing country risk assessments, the licensee should take into account:

a. The size and maturity profile of its foreign assets;

b. Fiscal, monetary, exchange rate and financial sector policies of foreign countries;
c. Official reserves, balance-of-payments, terms of trade and other macroeconomic variables;
d. Social and political stability as well as the legal and regulatory environment of the country; and
e. The country's record in servicing and repaying external debt.

In addition, licensees should have regard to the availability of statistical information on foreign countries from both domestic and international sources. Some sources of information that licensees can utilize to conduct country risk assessments include:

a. Internal and external country analysis reports;
b. Business periodicals;
c. Various types of governmental publications; and
d. Other reference materials such as rating information and updates provided by external rating agencies.

Licensees should maintain formal risk assessment files and the results of risk analyses should be integrated into assigning country ratings, setting country exposure limits as well as provisioning.

4.1.1 Country Risk Ratings

Country risk ratings summarise the conclusions of the country risk assessment process. The ratings are a critical component of the overall risk management since they provide a framework for establishing country exposure limits that reflect the licensee's tolerance for risk. The sophistication of the rating system should be consistent with the size and complexity of the licensee's cross-border exposures and operations.

Some key issues that licensees should consider in developing their country risk rating systems are set out below:

a. Risk ratings should be assigned at least annually to every country with which the licensee has an exposure. Ratings should be based on the results of the country risk assessments;
b. Clearly defined country risk categories (e.g. numerical or alphabetical) and detailed criteria and characteristics of each rating category should be established;
c. The country risk ratings should be integrated into the loan classification framework; and
d. The ratings should be utilized in assessing the appropriate level of provisioning.

Although licensees have access to ratings assigned by external rating agencies, they should not rely solely on these ratings but may consider these ratings in forming their own assessment and for validating, on a regular basis, the effectiveness of their rating system.

4.1.2 Country Limits

As part of their risk management process, licensees should establish country risk limits. These limits should reflect the perceived economic strength of the country and the licensee's perceived business opportunities in the country as well as its risk appetite. Country limits should be reviewed and approved annually and should reflect the results of the country risk assessments.

The framework for setting country exposure limits should apply to all on and off balance sheet exposures and should be robust enough to allow licensees to implement sub-limits within the overall limit. These sub-limits may, for instance, be based on:

a. Maturity (short, medium or long term);
b. Type of country risk exposure (e.g. transfer, currency, etc);
c. Type of borrower (e.g. sovereign government, financial institutions, corporate etc);
d. Currency;
e. Type of product (investment or loan type); and
f. Region.

4.2 Country Exposure Measurement

Licensees should have systems for measuring country exposure. Country risk exposure refers to an individual licensee or group of related licensees' exposure in terms of claims on borrowers/investees in individual foreign countries. Measurement of country exposures should incorporate outstanding balances and undrawn commitments. This would include letters of credit and legally binding commitments to lend to foreign clients. The measuring system adopted by the licensee should be suited for the size and complexity of its international lending and investment activity. It should be comprehensive enough to capture all exposures while permitting an analysis of the different types of country risk.

To adequately measure country risk exposures, a licensee should develop a measurement system that, at a minimum:

a. Is capable of incorporating transfer risk. A major difficulty with measuring country exposures is determining where the final risk lies. This arises as a result of the guarantees or securities taken by the licensee. The guarantee taken may result in a claim against a country different to where the loan has been extended. As such, the system should therefore allow for a straightforward measurement by country and then another calculation that would account for risk transfer based on where the underlying risk lies;

b. Measures country exposures on a solo[1] and consolidated[2] basis, as applicable. Licensees should measure country risk exposure on a consolidated basis so as to determine its overall exposure to foreign borrowers outside of its own operations. This measurement would embrace the international activity of the licensee's branches, subsidiaries and other related parties; and
c. Measures and provides a breakdown of different types of exposures. The system should allow for the analysis by country by providing breakdowns such as by type of claim (loan, investment), type of borrower, maturity among others.

Licensees should not offset deposits from a country against credits to that country unless the licensee has established a legal right of set-off vis-à-vis the same customer. However, licensees should be cognizant that legal actions by third parties may prevent the licensee from enforcing its right of set-off.

4.2.1 Country Risk Provisioning

Licensees should set aside provisions to absorb potential losses from exposure to country risk. Essentially there are two approaches that can be adopted for provisioning:

a. Provision against the aggregate exposure to a particular country after accounting for any transfer and specific provision made against credit risk; or
b. Factor in the provision for country risk as an element directly into specific provisioning for each individual exposure.

Regardless of the approach used, licensees should ensure that country risk provisions are adequate, based on their assessment of the possible losses that could arise from cross border exposures. Licensees, however, need not make additional provisions solely for country risk if they are satisfied that their current level of general and specific provisioning is sufficient to absorb potential losses from both credit and country risks.

The process for provisioning should be documented in the licensee's provisioning policy and should specify criteria to determine when and how to compute provisions for country risk. Additionally, the policy should outline the accounting procedure for the recording and disclosure of country risk provisions.

[1] Solo refers to a licensed institution subject to supervision as a 'stand-alone' entity.
[2] Consolidation in this sense refers to the totality of the operations of the licensee's branches, subsidiaries, other related licensees and significant participations.

Monitoring and Controlling Country Risk

Each licensee must be in a position to identify country risk exposure by having a system in place to periodically monitor conditions in countries to which they are exposed. This monitoring should be enhanced by a system of centralised risk management that is integrated with the licensee's overall credit risk management.

The monitoring process allows the licensee to assess its compliance with its established country limits and sub-limits and to identify any exceptions. The procedures and processes to be followed in monitoring country conditions should be documented and adequately communicated to the relevant staff by management. It should detail the corrective actions including possible exit strategies to be implemented as a result of deteriorating conditions within a particular country. The frequency of monitoring for individual countries will depend on the perceived volatility of their economic, social and political conditions. However, all countries should be reviewed at least annually.

A summary of the reviews should be reported to senior management in a timely manner to enable them to adequately assess the licensee's aggregate exposure to country risk. The Board should also receive management reports on the licensee's exposure. These reports should be used to assess the appropriateness of the country limits. Refer to the Credit Risk Management Guideline provides further details on the monitoring process.

4.2.2 Internal Control and Independent Review

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. Some licensees may consider incorporating the review of country risk into the scope of the external auditor's work, where the scale and complexity of the licensee's exposures warrant. The system of internal controls should, as far as possible, depending on the size and nature of the licensee activities, allow for a segregation of responsibilities related to the assessment and rating of country risk and the setting of country limits.

4.3 Stress Testing

The development of a stress-testing program should form an integral part of a licensee's country risk management process. It provides an avenue that allows licensees to estimate their risk exposures under stressed conditions and develop appropriate strategies to mitigate the risks. Licensees should, commensurate with the significance of foreign exposures, periodically stress test their foreign country exposures and report the results to the Board and senior management. In devising stress scenarios, licensees should consider incorporating co-variance analysis to adequately address the possibility of contagion. For further details on the overall stress testing process, refer to the Guideline on Stress Testing.

5. ROLE OF THE BANK

Licensees are expected to implement a country risk management program that has adequate policies and procedures for identifying, monitoring and controlling country and transfer risk in their international lending and investment activities and maintain appropriate provisions against these risks.

In reviewing a licensee's country risk management program, the Bank will assess:

a. The level of oversight exercised by the Board and senior management;
b. The adequacy of policies and procedures for managing country risk;
c. The system for assessing, measuring, monitoring and reporting country risk exposures;
d. The country risk rating system;
e. The adequacy of provisioning for country and transfer risk;
f. Stress testing results; and
g. The adequacy of internal controls and the audit function.

The Bank will assess the country risk management by licensees through onsite inspection of the policies and procedures implemented to mitigate this risk. In its country risk management assessment, the Bank will examine the size and complexity of the licensee's international lending and investment activity. The Bank will conduct periodic reviews of the level of country and transfer risk provisions made by individual licensees and may, on a case-by-case basis, require licensees to reassess their country risk provisions if there are grounds to doubt the adequacy of the existing provisions.

The Bank will receive quarterly reports from licensees that indicate:

a. The level of foreign exposure;
b. The exposures to individual countries that exceed 25% of regulatory capital; and
c. Provisions and recoveries made against country risk.

Appendix 1

SOURCES OF COUNTRY RISK

Country risk in itself comprises a number of risks to which licensees should be aware of their level of exposure. The following are types of country risk:

1. **Transfer risk**. The risk that a borrower may not be able to secure foreign exchange to service its obligations.

2. **Sovereign risk**. This represents the capacity and willingness of a foreign government to repay its direct and indirect (i.e. guaranteed) foreign currency obligations.

3. **Contagion risk**. This relates to the situation where adverse developments in one country lead to a downgrade of rating or a credit squeeze not only for that country but also for other countries in the region.

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. **Indirect country risk**. The risk that the repayment ability of a domestic borrower is endangered owing to the deterioration of the economic, political or social conditions in a foreign country where the borrower has substantial business relationships or interest.

6. **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.