Methodological Instruction of the Banking Supervision Division No. 7/2003 on the country risk management

Purpose

Act No. 483/2001 Z. z. on Banks states in Article 32 para 3 letters a) and b) the obligation for banks and branch offices of foreign banks to observe the prudential banking regulations in a way not to overstep the established ratios of large exposure to own funds or to assets or groups of assets relating to other countries and geographical regions.

The National Bank of Slovakia has not established the limits of large exposure relating to other countries and geographical regions, however, according to the Act, banks have the obligation to manage the risk following from these exposures.

The National Bank of Slovakia issues this methodological instruction on country risk management for banks and branch offices of foreign banks.

This instruction is included in the category of the **"Process of risk management"**.

Contents

The given instruction defines the country risk and lists the components of the effective management of the country risk in its first part. In the second part of the instruction the process of the country risk management is described in detail.

Definition

The country risk represents the risk that a sovereign debtor (government, central bank) in any country will not be able or willing to fulfill its obligations vis-a-vis other foreign countries, and other debtors in this country will not be able to fulfill their obligations because they are residents of this country.

Components of the efficient country risk management

The efficient process of the country risk management includes the following steps:

- efficient oversight by the bank management,
- reasonable policy and procedures of the risk management,
- relevant system of measuring and reporting,
- effective process of country risk analysis and the rating of individual countries,
- determination of large exposure limits for individual countries,
- regular evaluation of conditions in individual countries,
- adequate mechanisms of internal control.

1. The efficient oversight by the bank management

The bank management is responsible for:

- approval of the bank policy regarding its international activities in accordance with the strategic goals of the bank,
- review and adoption of large exposure limits for individual countries and geographical regions,
- regular control of large exposures and of compliance with the established limits.

2. The reasonable policy and procedures of the country risk management

The bank management is responsible for the preparation and implementation of the approved policy with clearly defined procedures for the country risk management. The management should clearly define in its organizational structure the persons, committees and organizational units of the bank which are responsible for the country risk management in such a way that the separation of the risk management and the performance of bank activities are ensured.

The implementation of the bank policy for the country risk management should focus on:

- determination of exposure limits for individual countries and geographical regions,
- determination of obligations and responsibilities in the process of the country risk management,
- definition of the eligible and not eligible types of trades.

3. The relevant system of measuring and reporting

The system for the measurement of the bank large exposures to individual countries should be adjusted to the character and scope of the bank external activities; owing to this, it is not possible to define the single system of measurement suitable for all banks. Banks should have the system for the complex evidence of all significant exposures, and this system should provide the sufficiently detailed information for risk analyses performed by banks. The system should involve all the spheres of bank activities in other countries.

The system of the bank large exposure measurement should regularly provide the management of the bank with the information about large exposures of the bank abroad. The suitable frequency and structure of reports for the bank management depend on the importance of the bank activities in abroad and on the type of trades with external entities.

The system of the large exposure measurement should allow a bank to follow the individual exposures according to three aspects:

1. considering the reallocation of risks
2. monitoring the exposures on the consolidated basis
3. monitoring the exposures according to individual countries

Reallocation of risk

The reallocation of risk represents the possibility that the final risk following from the large exposure is in a country other than the country of the original debtor. For this reason, it is useful to monitor the exposures according to two basic criteria:

1. the country of debtor
2. the country in which the final risk is allocated

The country of debtor represents the country in which the debtor is resident. The country in which the final risk is allocated represents the country to which the risk was transferred. The transfer of risk may be caused by more factors, e.g. guarantee for a granted loan is provided by an entity from a country other than the country of debtor, or the resident is a branch office of a foreign bank.

Monitoring of exposures on the consolidated basis

The monitoring of large exposures on the consolidated basis also, is a tool for obtaining a complex view on the large exposure of a bank to debtors from other countries. In this regard the bank should monitor the following exposures:

1. total large exposures of a consolidated group to individual countries,
2. total large exposures of a bank to its foreign branches and subsidiaries,
3. individual large exposures of individual foreign branch offices and of individual members of a consolidated group.

Monitoring of exposures according to individual countries

The large exposure of a bank to an individual country includes all balance-sheet and off-balance-sheet trades of a bank vis-a-vis debtors which are residents of the given country. The total large exposures of a bank to the country are useful to be monitored according to a number of criteria, e.g.:

1. balance-sheet and off-balance-sheet trades
2. residual maturity
3. contracted maturity
4. type of debtor (sovereign debtor, bank, corporate, retail, etc.)

4. Effective process of the country risk analysis and the rating of individual countries

The risk analysis of individual countries performed by a bank depends on the size of its exposure abroad and on the funds spent on the analysis.

The process of the country risk analysis should include at minimum these aspects:

- analysis should contain sufficient number of quantitative and qualitative indicators assessing the risk of the country to which the bank is or plans to be exposed,
- analysis of individual countries should be done at minimum once a year, and in the period between individual analyses the effective system of monitoring the country development should by ensured,
- analysis should contain all components of the country risk as well as the risks connected with the specific groups of counterparties on which the bank is focused in its business plan,
- analysis should be sufficiently documented and its conclusions should be sent to specific units of a bank so that all the organizational units, which take a decision on the amount of exposure of individual transactions, would have enough information for the decision,
- funds spent on the analysis of the country risk should be consistent with the scope and comprehensivness of the bank international activities,
- results of the bank's analysis should be compared with the analyses by external entities, e.g. rating agencies.

The country risk analysis usually includes three groups of indicators:

- political risk indicators,
- economic risk indicators,
- financial risk indicators.

Political risk

The determination of the political risk rating is aimed at the assessment of the political stability of a country.

The political risk parameters, useful to be monitored, are as follows:

- government stability
- social and economic conditions
- investment environment
- internal conflicts in the country
- external conflict of the country

Economic risk

The determination of the economic risk of a country is aimed at the assessment of the overall economic strength of a country.

The parameters of the economic risk, useful to be monitored, are as follows:

- GDP per capita
- GDP growth
- inflation rate
- state-budget balance to GDP
- the ratio of balance of payments current account to GDP

Financial risk

The goal of determining the financial risk rating is to provide a means for evaluating the ability of a country to repay its external obligations.

Among the financial risk parameters, useful to be monitored, belong:

- external debt to GDP ratio,
- debt service to annual exports ratio,
- balance of payments current account to annual exports ratio,
- foreign exchange reserves to cover imports in months,
- exchange rate stability.

Assigning a sovereign rating grade to a country summarizes the conclusions of a country risk analysis. It is an important part of the risk management, as it provides a framework for the determination of exposure limits which reflect the bank_s willingness to take a risk. The risk rating of a country can be determined differently for different types of transactions and partners, as governments of individual countries prefer certain trades and also set more favourable conditions for their repayment.

The analysis and assessment of country risk is a complex process that cannot be unified for the whole banking sector. Banks should create their own rating procedures for individual countries, or they can use external ratings by agencies dealing with the country risk assessment.

There exist more agencies dealing with the assessment of country risk and assigning sovereign ratings, e.g. Standard & Poor's, Moody's, Fitch IBCA, and others. Data can be obtained from international institutions such as the World Bank and the International Monetary Fund. An important source of information can also be the International Country Risk Guide published by the PRS Group, or the International Risk & Payment Review published by Dun & Bradstreet.

5. Determination of large exposure limits for individual countries

Based on the analysis of individual countries and the bank's business plan, the bank should set large exposure limits for individual countries and geographical regions.

Determination of the limits for individual countries should take into account:

- bank's strategy in its international activities,
- risk of a certain country and the bank's willingness to take the risk,
- search for trading opportunities abroad,
- promotion of international trading activities of domestic clients.

The large exposure limits for individual countries should be approved by the bank management or by an appropriate bank's committee. The bank should review the established limits regularly. The limits should be regularly observed in the bank, and the bank management should be informed about exceeding the limits.

In determining the limits it should be considered whether there will be one limit for all activities, or the limit will be broken by individual products, sectors or by the types of trading partners.

When establishing limits for individual countries it would also be appropriate to consider a wider, regional framework, as problems in one country can also affect other countries in the region. Moreover, similar influences can also exist in the countries geographically distant but with strong political or economic links.

6. Regular evaluation of conditions in individual countries

The bank should constantly monitor conditions in the countries in which it is exposed to the risk. The sources expended on the monitoring should be adequate to the degree and range of exposures as well as to future exposures. It is helpful to utilise information from its own branch offices or representative offices in the given countries, or from rating agencies.

7. Internal control

The bank should implement the appropriate system of internal control of the country risk management process, a part of which system is the evaluation of compliance with rules for the country risk management as well as an independent review of the effectiveness of the country risk management system.

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Ing. Milan Horvath
Chief Executive Director
Banking Supervision Division