BANK OF JAMAICA

# STANDARDS OF SOUND BUSINESS PRACTICES

# COUNTRY AND TRANSFER RISK

# STANDARDS OF BEST PRACTICE ON COUNTRY AND TRANSFER RISK

## A. PURPOSE/OBJECTIVE

This document sets out the minimum structures, policies and procedures that each licensee needs to have in place for identifying, monitoring and controlling country and transfer risk in international lending and investment activities and for maintaining appropriate capital and/or reserves against such risks.

Lending and investment activities involve a number of risks. In addition to risks related to the credit worthiness of the borrower, for example, there is also funding risk, interest rate risk and foreign exchange risk among others. International or cross-border lending and investments also involve country risk. A wide variety of factors may give rise to country risk and all licensees must be aware of its existence and the need for a system of assessing, measuring and controlling that risk as part of managing their lending and investments portfolios.

This Standard focuses solely on the direct exposure of a licensee/group to country risk emanating from international or cross-border exposures on a solo as well as consolidated basis. It does not deal with the related risks to which a licensee and the consolidated group may be exposed to when it lends domestically to a borrower who may in turn be exposed to the risk of default by a foreign counter-party. As part of the overall risk management of each licensee, it is expected that the country risk management process will be triggered as soon as international lending or investments are contemplated.

## B. APPLICABILITY

These Standards, which cover the minimum requisite framework for country risk management, are applicable to the following financial institutions and the financial groups to which they belong, which carry on activities within Jamaica:

- Commercial banks licensed under the Banking Act;
- Financial institutions/merchant banks licensed under the Financial Institutions Act;
- Building societies licensed under the Building Societies Act;
- Cooperative societies that operate as credit unions (to be licensed under the Bank of Jamaica (Credit Union) Regulations;

## C. LEGAL STATUS

The Standards of Best Practice do not by themselves have the force of law. However, indication of direct contravention or non-observance of the Standards by licensees would be regarded by the Bank of Jamaica as evidence of 'unsafe and unsound' business practice. Institutions should also be aware of the specific provisions of Section 25(1) of the Banking Act and the Financial Institutions Act, which give the BOJ the authority to administer varied measures against an institution for inter alia, any contravention of the Standards issued by the Supervisory Authority.[1]

## D. DEFINITION

Country risk refers to the possibility or risk that a foreign borrower may be unable or unwilling to fulfill his foreign obligations due to <u>country-specific conditions</u>, which may be underlying economic, political, social, natural or other events and trends. A wide variety of factors may prevent borrowers from a given country from fulfilling their foreign obligations. These may include the consequences of exchange control, currency devaluation, official government actions or important socio-political changes in the borrowing country, largely unpredictable events such as natural disasters or external shocks arising from global phenomena such as the consequences of World Trade Organization (WTO) rulings or an oil price rise. Country risk, which may have an overarching effect on the realization of a licensee's assets, encompasses all of the uncertainties arising from the economic, social and political conditions in a country.

Thus, country risk does not include the credit risk specifically associated with the borrower (individual counter-party risk) but stems form country-specific issues and is measured and monitored (on a solo and consolidated basis) according to where the risk is domiciled rather than where the debtor is domiciled.

Licensees should be aware of the different types of country risk to which they may be exposed. These include transfer risk, sovereign risk, contagion risk, currency risk, indirect country risk and macroeconomic risk.

Transfer risk is one facet of country risk and refers more narrowly to the risk associated with the availability of foreign currency to service a country's external debt. It also relates to the impact of devaluation and other factors that affect the overall availability of foreign exchange and hence a borrower's ability to honour his obligations abroad including a foreign authority placing restrictions on transfers.

Sovereign risk refers to a foreign government's capacity and willingness to repay its direct and indirect (that is, guaranteed) foreign currency obligations.

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[1] Refer to Second Schedule, Part A 2(b) of the Banking Act, the Financial Institutions Act.

Contagion risk refers to situations where adverse developments in one county lead to a downgrade of rating or a credit squeeze, not only for that country, but also other countries in the same region or grouping, regardless of whether those countries may be more credit worthy or whether the adverse developments apply to them.

Currency risk refers to the risk that a borrower's domestic currency holdings and cash flow become inadequate to service its foreign currency obligations because of devaluation.

Indirect country risk refers to 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 interests.

Macroeconomic risk refers to the risk that a borrower in a country may be adversely affected due to measures taken by the government to defend its currency or to control inflation, for example, the impact of high interest rates.

Country risk assessment refers to the methods 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 exposure refers to an individual licensee or group of related licensees' exposure in terms of claims on borrowers/investees in individual foreign countries. Measures of exposure to a particular country may take account of guarantees or other factors that could shift risk to a different country to that of the borrower.

## E. COUNTRY RISK MANAGEMENT PROGRAMME

The management of country and transfer risk is the responsibility of the senior management of each licensee. Each licensee is required to formally develop, document and implement risk management programmes that include policies and procedures for identifying, assessing, measuring and controlling its exposure to country risk on a consolidated basis. Country risk management programmes should, at a minimum, satisfy the following:

1. Each licensee's country risk management policies should be approved by its board of directors.
2. Country risk management should be a part of the licensee's overall risk management process. Country risk management may however be integrated with credit and investment risk management on the approval of the board of directors, particularly as country risk may be an important consideration when evaluating the level of credit risk associated with individual counterparties in a particular country. In some countries, regardless of the availability of foreign exchange, macro-economic conditions, policies and events that are beyond the control of individual borrowers can strain the financial capacity of otherwise good credit risks.
3. Country risk management policies should cover a broad definition of country risk, including transfer risk and local currency/indigenous risks and, at a minimum, cover:
    a) the assessment of country risk;
    b) the measurement of country exposure;
    c) the control of a licensee's country exposure.
4. Country risk management policies should cover all types of credit and investment risk exposures.

5. Country risk policies should address both situations marked by actual or imminent payment arrears (backward-looking) and situations marked by increasing risk of payment arrears (forward-looking).
6. Each licensee's country risk management policies should be reviewed at least once annually by its board of directors.
7. Each licensee should develop internal country risk monitoring and reporting mechanisms. The type and content of country risk reporting to senior management, board appointed committees and the board of directors may vary from licensee to licensee but must, at minimum, ensure that the board of directors is appropriately apprised on a timely basis as to issues arising and adherence to policy.
8. Each licensee should implement appropriate internal controls to ensure that country risk management policies are being complied with.
9. Each licensee should assign responsibility for country risk management to a senior risk officer or appropriate high-level committee.
10. Each licensee should have established procedures to deal with deteriorating country risk situations.
11. Each licensee should maintain country risk analysis files that contain internally prepared analyses of economic/social/political and other risks associated with a particular country as well as external analyses prepared by rating agencies/consultants/multilateral agencies.

## F. COUNTRY RISK - ASSESSMENT, MEASUREMENT AND CONTROL

### 1. Assessment of Country Risk

The assessment of country risk is an essential part of the process of managing an international lending and investment portfolio, hence each licensee should have in place a country risk assessment system with sufficient resources to make it effective. In conducting assessments of country risk, in each case the licensee should have regard to the availability of statistical information on the country from both domestic and international sources. Where available, up-to-date domestic statistics as well as data produced from international organizations provide a useful starting point. Other sources of information required to conduct country risk assessments may include:

- Internal and external country analysis reports
- Business periodicals
- Various types of government publications
- Information obtained from correspondent bank clients (e.g. annual reports)
- Other reference materials such as rating information and updates provided by external rating agencies.

The key question behind country risk assessment is whether there will be impediments to the repayment of external debt, and hence the size, nature and maturity pattern of a country's external indebtedness are particularly significant. The licensee may also consider projecting a path to the country's external debt and forecast its ability to service and repay, which might mean looking at the outlook for official reserves and other balance-of-payments items, terms of trade, exchange rates, inflation, the country's record in servicing and repaying external debt and other relevant factors.

Regard should also be had to direct experience of local conditions and consideration given, where possible, to building representations or reliable contacts in countries where country risk exposure lie.

## 2. Country Risk Measurement

Systems for measuring country exposure need to be tailored according to the size and complexity of an individual licensee's international lending and investing operations. For the individual licensee, the objective is to maintain a system comprehensive enough to capture all significant exposures and detailed enough to permit adequate analysis of different types of risk.

A number of general problems arise in measuring country exposure that may be common to all licensees regardless of size or nature of business. Each licensee therefore needs to develop its country risk measurement system within a framework which:

a) <u>Makes Allowance for Risk Allocation</u>

One major difficulty with measuring country exposure is to determine where the final risk lies. In addition to allocating each claim according to the residence of the borrower, it will also be necessary to consider how to take into account additional factors which in practice may give the licensee a claim on a resident of a different country. Each licensee's system should therefore be capable of making two separate calculations of a country's exposure, one which is a straightforward breakdown by country of the borrower and the other which makes allowance for risk transfers of whatever kind.

This form of dual risk calculation may be relevant in the case of credits covered by legally binding guarantees from a resident of a country other than that of the borrower. The same considerations apply for collateral that is liquid and available in a country other than that of the borrower. The dual calculation also brings into the exposure analysis loans to domestic borrowers which are guaranteed by foreign entities and equally removes from the exposure, foreign lending which is guaranteed by domestic entities.

b) Ensures Consolidation

Each licensee should measure country exposure on a consolidated basis in order to obtain a picture of overall exposure to foreign borrowers outside of its own operations. Consolidation in this sense embraces the operations of the licensee's branches, subsidiaries, other related licensees and significant participations, and assists the licensee in the management of overall exposure to country risk. In addition to measuring its country exposure on a consolidated basis, the licensee should also take account of the gross country exposure arising from the funding of its individual overseas branches and subsidiaries.

Consolidation should in no way prevent the licensee from considering the country exposure of each of its foreign branches and subsidiaries and its own activities individually, as internal transactions, where they are cross-border, will themselves give rise to this exposure.

c) Capture the Breakdown and Analysis of Claims by Borrowing Country

Country exposure consists of all balance-sheet assets including loans, acceptances, placements, securities, etc., which represent claims on residents of another country. A breakdown of residual maturity of claims will assist in providing a comprehensive maturity profile of indebtedness. Additional breakdowns, for example, distinguishing between claims on sovereign borrowers, banks and others, will also assist the licensee's management to assess the licensee's exposure in a number of different ways.

All claims in a particular country should be recorded irrespective of currency. For licensees that conduct retail business in other countries through local offices, intra-country loans denominated in the local currency will be subject to country risk in a somewhat different sense as their repayment does not represent a call on the foreign exchange reserves of that country. Such loans may usefully be identified separately in a summary of exposure total.

Deposits from a country should not ordinarily be offset against credits to that country unless the licensee has established a legal right of set-off vis-à-vis the same customer. It should still then be considered that legal actions by third parties may prevent the licensee from enforcing its right of set-off.

Some potential claims that do not appear on the balance sheet may also involve country risk and the licensee should try to identify its true exposure in these instances. These include letters of credit and legally binding commitments to lend foreign clients which may expose the licensee in much the same way as a loan that has actually been drawn down. Licensees should monitor all commitments to provide funds regardless of their precise nature, including commitments arising from loans with draw-downs according to a pre-established schedule and even from market lines.

Licensees should be aware that fiduciary operations, where the licensee acts as an agent, may give rise to country exposure in certain circumstances. In such circumstances, these operations should be considered in determining country exposure.

## 3. <u>Controlling Country Risk Exposure</u>

Each licensee should develop and implement a country risk control process sufficient to establish, maintain, monitor and review individual country exposure limits. This process should normally take account of the size and nature of the licensee, the perceived economic strength of the country concerned and the licensee's spread of risk or existing portfolio diversification.

Overall exposure limits for each country to which the licensee extends or is considering extending credit or to invest should be set on prudential grounds only. Limits should be set formally within the framework of an established policy that culminates at a very senior level in the licensee and which enables the process to be integrated at the highest level with the direction of the licensee's board of directors. Limits should also be set for individual country exposure in relation to degrees of perceived risk and with reference to the licensee's capital and reserves, that is, the licensee's capacity to sustain losses in their business, and should apply both with and without risk reallocation. **(See Section E)**

It may also be advisable for each licensee to diversify its exposure within a major borrowing country by placing sub-limits on certain types of credits (for example, trade related credits, project loans, etc.), by type of borrower (for example, sovereign borrowers, banks, etc.), and/or by maturity (short-term, medium-term, long-term). Internal single and connected borrower limits (within allowed statutory limits) should also be applied to international borrowers even though not directly related to country risk.

Once limits have been set, they should not be breached without reference to the procedural safeguards behind their establishment. This may involve prior reference to and approval by the board of directors or other relevant policy making body.

Licensees' policies and procedures must provide for the regular review of country limits so that these may be raised or lowered in response to countries' changing risk profiles. Support for the limit setting process should come from the country exposure reporting and country risk assessment systems, and regular reviews must entail updates on country risk perceptions and the systematic comparison of exposures and limits.

Where problems arise with existing credits, licensees will need to consider the nature and extent of their exposure, which might include working out arrangements with borrowers, with due regard to the overall circumstances.

Each licensee should establish a system to assess and measure potential losses arising from country and transfer risk, and to determine prudent levels of reserving and provisioning. The board of directors must ensure that the required levels of provision and reserving in this regard, is maintained on an ongoing basis. Provisions should be made immediately against expected losses and losses should be written off as appropriate.

## G. ROLE & RESPONSIBILITIES OF BOARD OF DIRECTORS AND SENIOR MANAGEMENT

Effective oversight by a licensee's Board of Directors and senior management is critical to a sound country risk management process and compliance with this Standard. The Board has overall oversight responsibility including:

- ensuring that senior management implements and adheres to the country risk management policy approved by the Board; and
- the taking of corrective action(s) for breach of the policy, limits and provisions established under the policy or the provisions and spirit of the Standard.

There should be procedures in place for the approval of a licensee's country risk management policy and for ensuring that senior management adheres to that policy and implements appropriate measures to identify, monitor and control country and transfer risk.

Senior management is responsible for the implementation of the country and transfer risk policy approved by the Board and the development of detailed procedures, where necessary to supplement and support that policy. Management should ensure that any significant change in the conditions of a country is brought to the attention of the Board of Directors promptly, especially where the licensee has a substantial exposure to that country.

In carrying out its responsibilities, management should ensure that the country risk management programme and supporting processes and procedures take account of the licensee's business strategy in overseas countries, the parameters under which such business is carried out, as well as its risk appetite and risk tolerances given available financial resources, staff skills and systems for country risk identification, measurement, monitoring, reporting and provisioning. Management should at minimum establish:

- Clear lines of authority (including approval of cross-border lending and exceptions), responsibilities and accountabilities;
- The types of country and transfer risk which may be incurred by the licensee and the processes and procedures for managing them;
- The overall limits and sub-limits for cross-border exposures;
- The standards and criteria which the licensee will use to analyze the risk of particular countries;
- The internal country rating system, if any, or how the country risk elements are factored into the licensee's existing loan classification system;

- The method to be used in measuring country risk exposures;
- Types of and criteria for acceptable collateral and guarantees, financial instruments and hedging strategies which are to be allowed for the mitigation of country risk and the requirements for perfection of collateral;
- Procedures for dealing with deteriorating situations in a country, with clear contingency plans and exit strategies; and
- Types of management reports on country risk.

## H. SUPERVISION AND REGULATORY REPORTING

### 1. Supervision

Under Principle 12 of the Basel Committee's "Core Principles for Effective Banking Supervision" banking supervisors should be satisfied that licensees under their supervision have adequate policies and procedures for identifying, monitoring and controlling country and transfer risk in international lending and investment activities and for maintaining appropriate provisions (reserves) against such risks.

In reviewing the efficacy of a licensee's country risk management and the adequacy of provisions, the Bank of Jamaica will determine whether the licensee:

- has appropriate policies and procedures for the management of country risk;
- has a robust system for assessing and measuring the country risk in its cross-border exposures;

- has proper controls (for example, through establishing and monitoring country exposure limits) in place to manage the concentration risk associated with such exposures;
- devotes adequate resources to managing country risk;
- maintains adequate provisions for country and transfer risk;
- undertakes country risk reporting in accordance with the licensee's policies and the provisions of this Standard; and
- applies its country risk management programme on a consistent and ongoing basis.

In its assessment the Bank of Jamaica will also have regard to the size and complexity of the licensee's cross-border business on a consolidated basis and other factors set out in this Standard.

The Bank of Jamaica will conduct regular 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 whether the existing provisioning level is adequate.

Where the Bank of Jamaica does not stipulate requirements for the credit and investment classification and provisioning levels for country and transfer risk exposures (including in relation to countries experiencing repayment or other difficulties), a licensee should not take this as a reason for deferring, or not conducting their own country risk and provisioning assessment. **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.**

## 2. Regulatory Reports

Each licensee should report country and transfer risk provisioning levels to the BOJ on a periodic basis in accordance with prudential reporting requirements established by the BOJ from time to time. Country and transfer risk provisioning levels should be computed and reported separately from provisions related to specific counterparty credit risks.

Each licensee should establish systems and procedures to capture information necessary to facilitate compliance with the prudential reporting requirements and to ensure the accuracy and consistency of its reporting on country and transfer risk to the Bank of Jamaica.