Statement of Guidance

Country and Transfer Risk Management by Banks

1. Statement of Objectives

1.1. To provide guidance on the accepted level of risk associated with international banking activities, in reference to country and transfer risk.

2. Introduction

2.1. Background

2.1.1 When a bank engages in international lending or incurs a cross-border exposure, it undertakes not only customary credit risk but also country risk. Country risk is the primary factor that differentiates international lending from domestic lending. It encompasses all the uncertainties arising from the economic, social and political conditions of a country that may cause borrowers in that country to be unable or unwilling to fulfil their external obligations.

2.1.2 Country risk may arise from deteriorating economic conditions, political and social upheavals, nationalisation or expropriation of assets, government repudiation of external indebtedness, exchange controls and currency devaluation.

2.1.3 Country risk is a special form of risk over which banks can exercise little direct influence. A bank should therefore ensure that they have adequate systems and expertise to manage their cross-border exposures and avoid taking undue concentration risks on such exposures.

2.1.4 The level of sophistication of a bank's country risk management system (see section 3.2 below) should be commensurate with the size, nature and complexity of its cross-border exposures.

2.2. Types of country risk

2.2.1 Banks should be aware of the different types of country risk to which they may be exposed. The main categories of country risk comprise sovereign, transfer and contagion risk.

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

2.2.3 *Transfer risk* is the risk that a borrower may not be able to secure foreign exchange to service its external obligations. Where a country suffers economic, political or social problems, leading to a drainage in 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.

2.2.4 *Contagion risk* arises where adverse developments in one country lead to a downgrade of rating or a credit squeeze not only for that country but also other countries in the region, notwithstanding that those countries may be more creditworthy and that the adverse developments do not apply to them.

2.2.5 Other categories of country risk include:

a) *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;
b) *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 relationship or interests; and

c) *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.

3. The Guidance

3.1. Supervisory approach

3.1.1 Under Principle 11 of the Basel Committee's "Core Principles for Effective Banking Supervision", banking supervisors should be satisfied that banks under their supervision have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities and for maintaining appropriate reserves against such risks.

3.1.2 In reviewing the effectiveness of a bank's country risk management and the adequacy of provisions made, the Authority will determine;

a) whether the bank has appropriate policies and procedures for the management of country risk;
b) has a robust system for assessing the country risk in its cross-border exposures;
c) has proper controls (e.g. through establishing and monitoring country exposure limits) in place to manage the concentration risk associated with such exposures;
d) devotes adequate resources to managing country risk; and
e) maintains adequate provisions for country risk.

3.1.3 The Authority will have regard to the size and complexity of a bank's cross-border business and other factors set out in this module in considering whether it has appropriate systems to control country risk and maintains adequate provisions for such risk.

3.1.4 It should be stressed that the primary responsibility for establishing adequate country management systems and determining the appropriate level of country risk provisions rests with a bank's management and/or Board of Directors.

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

3.2. Country risk management

3.2.1 Management oversight

a) Effective oversight by a bank's Board of Directors and senior management is critical to a sound country risk management process.
b) There should be procedures in place for the approval of a bank's country risk management and provisioning policy (*see subsection 3.2.2 below*) and for ensuring that senior management adheres to that policy and implements appropriate measures to identify, monitor and control country risk.
c) The Board should review regularly the bank's country risk exposures. Any significant changes in the conditions of a country should be brought to the attention of the Board promptly if the bank has substantial exposure to that country.
d) In the case of branches, the Authority accepts that country risk management will usually be undertaken by their head offices on a group basis. Where the Authority is not satisfied that the Cayman Islands Branch's country risk exposures are adequately managed, it reserves the right to require measures to be taken by the bank

concerned to make up for any deficiencies.

3.2.2 Policy and procedures

a) Banks should have a clearly defined policy, documented in writing and approved by the Board of Directors, the Credit Committee or senior management under delegated authority, for country risk management and provisioning.

b) The details to be included in the policy, and any procedures drawn up in respect of them, depend on the nature and scope of a bank's cross-border activities. Generally, they should set out the bank's business strategy in overseas countries, the parameters under which such business is carried out, its risk appetite and risk tolerances in the light of available financial resources, staff skills and systems for country risk identification, measurement, monitoring, reporting and provisioning.

c) The policy and any corresponding procedures would normally include, but is not limited to the following:

- clear lines of authority (including approval of cross-border lending and exceptions), responsibility and accountability for country risk management;
- types of country risk which may be incurred by the bank and the policies and procedures for managing them (in particular whether the bank's country risk management process is centralised or decentralised and integrated with the bank's overall credit risk management);
- the overall limits and sub-limits for cross-border exposures (see subsection 3.7 below);
- the standards and criteria which the bank will use to analyse the risk of particular countries;
- the internal country rating system, if any, or how the country risk elements are factored into the bank's existing loan

classification system;
- the method to be used in measuring country risk exposures;
- the country risk provisioning policy and methodology (see subsection 4.1 below);
- types of and criteria for acceptable collateral and guarantees, financial instruments and hedging strategies (e.g. credit derivatives or netting arrangements) which are allowed to be used for the mitigation of country risk and the requirements for perfection of collateral;
- the minimum standard terms and conditions to be incorporated in loan documentation in accordance with the legal requirements of each country;
- the requirement for registration, if applicable, of credit granted and guarantees accepted, non-compliance with which may render the exposure or guarantee not legally enforceable by the bank;
- lists of designated lawyers for evaluating the legitimacy of documentation and 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.

3.2.3 The policy should be reviewed at least annually to determine if it is still appropriate for the bank's business and compatible with changing market conditions.

3.2.4 Senior management is responsible for monitoring implementation of the policy and developing detailed procedures, where necessary, to supplement the policy.

3.3. Lending Principles

3.3.1 Banks should ensure that facilities granted to overseas borrowers are subject to the basic prudent credit granting criteria applicable to domestic exposures. For example, the principle of "know your customer" should be upheld.

3.3.2 There are many ways in which exposures can become related to countries and thus create risk concentrations. Banks should therefore ascertain the identity and the ultimate ownership of the borrowers, regardless of their place of incorporation and the complexity of their group structure. Where appropriate, banks should obtain written evidence or confirmation from relevant parties of the identity of borrowers and their shareholder structure in name and percentage terms.

3.3.3 Credit should only be granted to creditworthy borrowers and due diligence should be carried out. Banks should not simply lend on the basis of the name or official status of a borrower or rely on any implicit governmental guarantee. Banks should satisfy themselves that the borrowers have sufficient foreign currency assets or income streams to service their foreign currency obligations.

3.3.4 Banks should not lend on the basis of inadequate information.

3.3.5 Banks should not grant facilities to a particular economic sector purely based on government direction or benefits provided by the government such as tax concessions. They should place greater weight on borrowers' repayment ability and the risks of and return from each transaction.

3.3.6 Some countries are undergoing a process of economic development and restructuring. The infrastructure of commercial laws and regulations may not develop at the same pace. In larger countries, owing to the needs of different regions a lack of uniformity in laws and regulations and the interpretation of central directives by regional and provincial governments may exist. Banks should therefore beware of the assumption that what applies in one region or province applies in another. In case of need, banks should seek advice from external counsel and get clearance from the relevant authorities.

3.3.7 Before accepting collateral covering overseas exposures, banks should ensure that there has been full compliance with statutory procedures to strengthen validity and enforceability. Where tangible collateral such as land and buildings in the country concerned is taken, banks should ensure that the pledgor has good title to the collateral and that any valuation reports are reliable. To this end, banks should ensure that they have the appropriate legal advice with respect to the legitimacy and enforceability of loan agreements, guarantees and other documentation.

3.4. Staffing and organisation

3.4.1 Banks should dedicate adequate resources to the country risk management process, taking into account the extent of their involvement in cross-border business.

3.4.2 Banks should ensure that their internal control systems for country risk management are adequate and the staff responsible for the function is competent and equipped with the necessary knowledge and skills to undertake their duties.

3.4.3 The staff concerned should familiarise themselves with the financial and monetary system and legal and regulatory framework of those countries (or different regions/provinces of a country if there is a lack of uniformity in laws and regulations among them) to which the banks have significant exposures and should seek independent professional advice where appropriate.

3.4.4 Country risk should preferably be managed on a centralised basis and integrated with the bank's overall credit risk management. Responsibility for country risk may be assigned either to a senior executive (e.g. a country risk officer) or to an appropriate committee. Banks may also establish a specialised unit or department to analyse country risk (see subsection 3.5 below), propose country exposure limits and carry out regular country reviews.

3.4.5 Irrespective of the structure adopted, the functions of analysing country risk, setting limits and monitoring the bank's country risk exposures should be carried out by persons independent of the business development function.

3.5. Country risk analysis

3.5.1 Banks with significant cross-border operations should have robust systems for monitoring economic, social and political developments in the countries to which they have exposure. In assessing the risk of a country, banks should consider both quantitative and qualitative factors of that country.

3.5.2 In developing quantitative assessments of the risk of a country, banks may take into account the size and maturity profile of its external borrowing as well as its macroeconomic variables (including forecasts), fiscal, monetary, exchange rate and financial sector policies and relevant statistics.

3.5.3 Factors typically used in qualitative assessments of country risk include the quality of the policy-making function, social and political stability and the legal and regulatory environment of the country. In particular, banks should have regard to the country's compliance with international standards and codes.

3.5.4 Banks should give special attention to business dealings and transactions with counterparties from countries that do not sufficiently comply with international standards, e.g. those that are not on the list of "Schedule 3" [1] countries.

3.5.5 Banks should be aware of the impact of changes in governmental strategy and policies. This is particularly important if banks have substantial credit exposures to a particular business sector or region in a country. The reduction or withdrawal of governmental support for a sector or region or changes in governmental policies may severely weaken the repayment ability of borrowers in that sector or region. banks should therefore keep abreast of economic policy in the countries in which they do business so as to identify the right sectors for business development, to avoid those, which are out of favour, and to adjust their country business strategies in an appropriate and timely fashion.

3.5.6 Banks may make use of a variety of internal and external sources for assessing country risk. They should conduct their own country risk assessment, instead of relying entirely on external assessment.

3.5.7 In times of instability and impending crisis, banks should consider taking appropriate actions, such as updating their analyses more frequently and expanding the scope of their country risk analysis.

3.5.8 Banks should maintain formal country risk analysis files. These files should be centralised at head office, with supplemental files in foreign branches or subsidiaries.

[1] The list of "Schedule 3" countries are noted in the "*Guidance on the Prevention and Detection of Money Laundering in the Cayman Islands*"

3.5.9 Country risk files should include but is not limited to:

a) analyses of political, economic and social issues of the country concerned;
b) situation reports submitted by country managers and credit officers;
c) reports from visits to the country concerned;
d) reports from outside economic research services and major rating agencies;
e) published economic data and analysis; and
f) copies of documentation approving limits, sublimits and exceptions to limits.

3.5.10 The results of country risk analysis should be integrated closely with the process of formulating marketing strategies, approving credits, assigning country ratings (see subsection 3.6 below), setting country exposure limits (see subsection 3.7below) and provisioning.

3.6. Country risk ratings

3.6.1 Banks should have a system in place to integrate the results of their country risk analysis (see subsection 3.5 above) into their internal ratings of borrowers.

3.6.2 Banks that have significant cross-border exposures or overseas investments and operations should consider establishing a formal country risk rating system. Detailed written policies and procedures for analysing, recommending and approving country credit risk ratings should be developed for this purpose. The sophistication of such systems should be consistent with the size and complexity of a bank's cross-border exposures and operations.

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

a) Country risk ratings should be assigned at least annually to every country (in particular for countries in emerging markets) where banks have substantial exposures. Banks should conduct an interim review of such ratings whenever a potential change occurs in the economic, political and social conditions of a particular country;
b) Banks should form an independent unit (e.g. a Risk Management Committee to assign country risk ratings. Such ratings should reflect the results of their country risk analysis;
c) Banks should not solely rely on ratings assigned by external rating agencies but they may have regard to these ratings in forming their own assessment and for validating, on a regular basis, the effectiveness of their existing system;
d) Banks should clearly define their country risk rating categories (e.g. numerical or alphabetical) and the characteristics and coverage (e.g. types of country risk included and types of exposure covered) of each rating category under their rating framework;
e) Banks should integrate the country risk rating system with their loan classification framework. For example, if the bank assigns an unfavourable rating to a country, it may need to downgrade all its exposures relating to that country; and
f) Banks should also use their country risk rating system to determine the appropriate level of provisions.

3.7. Country exposure limits

3.7.1 Banks should have a system for establishing, maintaining and reviewing country exposure limits. Country exposure limits should be approved annually and revised during the year in response to substantive changes in a country's risk profile.

3.7.2 A bank's country risk management policy should clearly specify which department or committee has the authority to approve country exposure limits and sub-limits and to approve exceptions. Exceptions to country exposure limits should require authorization by senior management or, depending on the size of the exception, the Board of Directors.

3.7.3 Country exposure limits should be set based on prudential grounds. They should not be viewed as business targets to be met. To ensure objectivity, banks should maintain a clear division of responsibility by separating the business development function from the limit setting and monitoring function.

3.7.4 Banks should ensure that the limits set for their cross-border lending are compatible with their overall strategic goals and that they have the requisite resources to administer lending levels at the targets set.

3.7.5 Banks should set exposure limits for individual countries (particularly for countries in emerging markets) and sub limits to manage and monitor country risk. Country exposure limits should apply to all on- and off-balance sheet exposures to foreign obligors.

3.7.6 Sub-limits may be divided by the following criteria:

a) Maturity (e.g. short term and long term);
b) Type of borrower (e.g. financial institutions, sovereigns and corporates);
c) Type of country risk (e.g. sovereign, transfer, "within foreign country", etc.);
d) Type of product (e.g. trade-related credits, self-liquidating loans, project financing, derivatives and other off-balance sheet exposures, etc.)

e) Secured and unsecured;
f) Insured and uninsured;
g) Industry or economic sector of the borrower; and
h) Region.

3.7.7 The credit officers and other relevant staff of a bank should be made aware of the country exposure limits.

3.8. Country exposure measurement

3.8.1 Systems for measuring country exposures need to be tailored to the size and complexity of individual banks' international lending operations. There is no single method of measuring exposure, which is appropriate for all banks.

3.8.2 As a general principle, banks should ensure that the system is comprehensive enough to capture all significant exposures and detailed enough to permit adequate analysis of different types of risk. To achieve this, banks' measurement systems, as a minimum, should:

a) Be capable of making two separate calculations of their country exposure, with and without risk transfer;
b) Measure country exposure on both a solo and a consolidated basis;
c) Be able to measure different types of exposures (e.g. foreign exchange and interest rate contracts); and
d) Provide a sufficient breakdown (e.g. by type of borrower, exposure, collateral, residual maturity, etc.) for analysis by country.

3.8.3 Exposure should take account not only of outstanding balances but of undrawn commitments. Banks should be conscious that, even where a commitment is not legally binding in principle, there may be a degree of moral pressure to honour drawings. Banks are recommended to follow a conservative approach in this regard.

3.9. Monitoring and reporting

3.9.1 As part of the credit monitoring process banks should have a system in place to monitor their compliance with country exposure limits and sub-limits. Exceptions should be reported, approved and rectified as laid down in the country risk management policy.

3.9.2 Banks should perform periodic credit reviews and monitoring of their overseas exposures to identify unusual developments and, if appropriate, initiate necessary actions to protect their interests.

3.9.3 Banks should have an effective system in place to generate management reports which are detailed enough for the senior management review and to identify exceptions in a timely manner.

3.10. Stress-testing

3.10.1 Banks should conduct stress-testing analysis of their country risk exposures as a way of monitoring actual and potential risks.

3.10.2 Such testing should include evaluation of the impact on a bank's country risk exposures, should various material underlying assumptions turn out to be wrong.

3.10.3 It should also include co-variance analysis to detect or cater for contagion risk, particularly for countries in the same region.

4. Country risk provisioning

4.1. Provisioning policy and approach

4.1.1 Country risk provisions generally refer to provisions set aside by banks to absorb potential losses arising from its country risk exposures.

4.1.2 There are essentially two common approaches that banks may adopt for country risk provisioning:

a) the first is to reflect country risk in 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); and
b) the second is to factor in an element of provision for country risk into specific provisioning for each individual exposure (i.e. on an individual obligor basis).

4.1.3 Whichever approach is adopted, banks should make sure that they have set aside adequate country risk provisions according to their assessment of the probability of losses arising from their cross-border exposures. They 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.

4.1.4 Banks should adopt a rigorous process for determining the appropriate level of provisions for their country risk. The process should be documented in their provisioning policy and approved by the Board of Directors, the Credit Committee or senior management with delegated authority.

4.1.5 Generally, there are three stages in the process of deciding an appropriate level of provision:

a) identifying countries with current or potential repayment difficulties;
b) analysing the nature of those difficulties and the extent of the country's problems; and
c) determining what proportion, at this point, of exposures to that country is unlikely to be repaid in full.

4.1.6 The policy should specify criteria for when to provide and how to calculate country risk provisions. It should also clearly indicate which party has the authority to decide the level of country risk provision.

4.1.7 The policy should also describe the accounting policy adopted for recording and disclosing such provisions in the accounts. That policy should be applied consistently.

4.1.8 Any country risk provisions made should be justifiable and properly approved and documented. Banks should agree such provisions, if material, with their external auditors.

4.1.9 Where a bank has an internal country risk rating system, it should clearly demonstrate how its country risk rating system links up with its provisioning methodology.

4.2. Location of provisions

4.2.1 In some cases, Branches may prefer to establish provisions in their country of incorporation even though the impaired assets are held in the Cayman Islands branch. This approach is acceptable to the Authority, though the right is reserved to seek confirmation, as appropriate, from the overseas head office and, if necessary, from the overseas supervisory authority that the provisions are adequate.

4.2.2 Some locally incorporated banks which are subsidiaries of foreign banks may wish their parent banks to guarantee the value of the loans instead of making provisions. This is acceptable to the Authority provided that the criteria set out in subsection 4.3 below are met. Such arrangements should be notified to the Authority in order that their acceptability can be determined.

4.3. Acceptance criteria for guarantees

4.3.1 To be acceptable in lieu of provisions against country risk, guarantees should meet the following criteria:

a) they should cover the total exposure to customers of the country concerned after risk transfer;
b) they should be unconditional and irrevocable. They should also be drafted so that, inter alia, the guarantor will not be released from the obligation by reason of any change in the underlying loan contracts and that the bank will not be estopped from claiming under the guarantee in the event that it reaches a compromise with the borrower;
c) the guarantors should fulfil their obligations on demand;
d) there should be proof that the guarantee is issued in accordance with the law of the country in which the parent is incorporated and that the guarantor has complied with all legal requirements for the issue of the guarantee;
e) the issue of the guarantee should have been approved by a resolution of the Board of Directors of the guarantor and the Board should undertake to notify the bank and the Authority, should the guarantor's situation change in a way which may materially and adversely affect its ability to honour the guarantee;
f) the supervisory authority of the guarantor should be aware of the arrangement and have no objection to it; and
g) the bank should undertake to disclose the fact that exposures are guaranteed in lieu of provisioning in its annual accounts in Cayman Islands.

4.4. Capital adequacy

For the purposes of calculating the bank's capital adequacy ratio, provisions earmarked against country risk should not be included in its capital base.