

**MANAGEMENT OF BANKS' INTERNATIONAL LENDING
(COUNTRY RISK ANALYSIS AND COUNTRY EXPOSURE
MEASUREMENT AND CONTROL)
(March 1982)**

Introduction

Lending involves a number of risks. In addition to risks related to the creditworthiness of the borrower, there are others including funding risk, interest rate risk, clearing risk, and foreign exchange risk. International lending also involves country risk.

This paper deals solely with the country risk of international lending. It does not deal with the related risk to which banks may be exposed when they lend domestically in the knowledge that the borrower may be exposed to the risk of default by a foreign customer, or to other foreign impediments that might endanger repayment of the banks' loans. The presence of country risk in international lending, however, does not mean that international lending necessarily entails more aggregate risk than domestic lending.

Part I of the paper deals with banks' assessment of country risk; Part II with the measurement of country exposure; and Part III with the control of banks' country exposure. Part IV sets out the Committee's views about the role of supervisors in monitoring banks' country risk assessment systems and their country exposure. Finally, as misunderstandings can easily arise from the use of different terminology in relation to country risk, an Annex to the paper contains suggested definitions of certain terms that are in frequent use.

I. Banks' assessment of country risk

Country risk is taken to refer to the possibility that sovereign borrowers of a particular country may be unable or unwilling, and other borrowers unable, to fulfil their foreign obligations for reasons beyond the usual risks which arise in relation to all lending. A very wide variety of factors may prevent borrowers of a given country from fulfilling their foreign obligations, which makes country risk a difficult concept to define with precision. The risks range from the consequences of official actions or important socio-political changes in the borrowing country to largely unpredictable events such as natural disasters or external shocks arising from global phenomena like world depression or the consequences of an oil price rise. A major complication is that the same events will affect borrowers in some countries more than in others and also have varying effects on different borrowers in the same country. Their impact will, moreover, tend to vary over time. Country risk assessment cannot therefore be an exact science, but an art in which a significant degree of unpredictability must be acknowledged.

All banks are aware of the existence of country risk and of the need for a system for assessing that risk as part of the process of managing their international lending portfolio. For most major banks the starting point is statistical information available from both national and international sources. For the more industrialised countries, banks may find domestic statistics more useful since they are often the most up-to-date. For developing countries, data produced by international organisations such as the IMF/IBRD, the OECD and the BIS may be more frequently resorted to. The analyst will of course wish to look at a wide range of macro-economic numbers and at the relationships between them that he believes are significant. Many banks operate sophisticated mechanical scoring systems, with certain risks being weighted numerically to produce country scores or ratings. Such systems can be useful, but should not be relied on too much since economic ratios based on past performance have quite limited predictive ability over the wide range of possible country risks.

Since the key question is whether there will be impediments to the repayment of external indebtedness, the size, nature and maturity pattern of a country's current external indebtedness are particularly significant. Unfortunately, these data can be the most difficult to establish, because of some countries' reluctance to undertake the collection of all necessary data or to reveal the true extent of their indebtedness. The analyst will nonetheless wish to project a path for countries' external debt and to forecast their ability to service and repay, which means 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.

Given the complexities, it is no surprise that banks, particularly large banks with diversified portfolios, recognise that forecasting risks over the life of a bank's credit exposure entails a substantial measure of judgement. Thus managerial assessments, if possible based on direct experience of local conditions about, for example, a given country's economic policy stance, its possibilities for development and in particular its social and political stability, have justifiably been given greater emphasis in recent years by many banks in assessing their country risk. At the same time, banks need to be careful in interpreting intelligence received from local representatives or other persons whose judgement may be coloured by marketing factors, in order that their analysis can set forth the risk without a sales bias.

Larger banks with greater analytical resources and access to better information through their branch networks, more frequent foreign visits and a larger number of business and government contacts tend to be better equipped than smaller banks to assess country risk. Smaller banks too, however, should have a capacity to make independent analyses of the country risks they incur and where possible to build up representation or reliable contacts in countries where their main exposure lies. Where a bank's exposure is in the form of syndicated lending and where the lead bank may be known to have a first-class risk assessment system, such independent analysis is still needed since a lead bank will probably

face a different set of credit risks and may well find a particular credit attractive for reasons which may not apply to other participating banks. There is, furthermore, no inherent guarantee that a syndicated credit is less risky than other forms of lending.

II. Banks' measurement of country exposure

Systems for measuring country exposure need to be tailored according to the size and complexity of an individual bank's international lending operations. There is thus no single method of calculating exposure which will be appropriate for all banks. For the individual bank, the objective is to maintain a system comprehensive enough to capture all significant exposure and detailed enough to permit adequate analysis of different types of risk. At the same time, a number of general problems arise in measuring country exposure which are common to all banks, whatever their size or nature of business. It seems sensible for banks to approach these problems in a broadly similar manner for three main reasons:

- to give banks some assurance that their system of measurement conforms at least to some minimum standards;
- to allow aggregation in summary form for banking groups nationally and globally for the statistical reference of all participants in the market; and thus
- to enable individual banks to assess their own exposure in comparison with others, information which will be of value to both senior management and supervisors.

With these benefits in mind, the Committee would commend to banks a framework in which banks' measurement systems should be set. The following suggested guidelines are, of course, in no way inconsistent with a more detailed analysis by individual banks, which can build varying degrees of sophistication into the overall framework as is appropriate to them.

(a) Allowance for risk reallocation

One difficulty in measuring country exposure is to determine where the final risk lies. The initial task is to allocate each claim according to the residence of the borrower, but it is then necessary to consider how to take into account additional factors which in practice may give the lending bank a claim on a resident of a different country. Country exposure may arise in either case in certain circumstances and, in view of the number of borderline situations in this regard, the Committee recommends that banks' systems should be capable of making two separate calculations of their country exposure, one of which is a straightforward breakdown by country of the borrower and the other of which makes allowance for risk transfers of various kinds.

In the case of funds placed with a foreign branch of another bank, for example, exposure may in practice be regarded as applying both in respect of the country in which the branch is situated and also in the country of the branch's parent. In order to take this into

account, banks can usefully make a dual calculation. The second calculation would bring into the country exposure measurement credits to branches of foreign banks located in the lending bank's own country.

Dual exposure measurement is also in order in the case of loans covered by legally binding guarantees from a resident of a country other than that of the borrower. Collateral that is liquid and available in a country other than that of the borrower may be considered in the same manner as guarantees for this purpose. The dual calculation should bring into the country exposure analysis loans to domestic borrowers which are guaranteed by foreign entities, and equally remove from the exposure foreign lending which is guaranteed by domestic entities, a common example of which will be credits guaranteed by a bank's own domestic export credit agency.

(b) Consolidation

The best way for management to obtain a picture of an international bank's overall exposure to foreign borrowers outside the bank's own organisation is by measuring country exposure on a consolidated basis. To be complete, such consolidation can usefully embrace the operations of the bank's branches, subsidiaries and significant participations.

While such consolidation is an essential aid to the management of the country exposure of the overall operation, it remains true that banks' internal transactions, where they are cross-border, will themselves give rise to country exposure. But, as well as measuring its exposure on a consolidated basis, a bank will need to be aware of the gross country exposure arising from the funding of its individual overseas branches and subsidiaries. In the same way, a bank will be wise to consider the country exposure of each of its foreign branches and subsidiaries, and of the head office itself, individually, and to draw the appropriate conclusions.

(c) 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 by residual maturity of claim should also be available to provide a comprehensive maturity profile of indebtedness. Additional breakdowns may also be desirable in order to enable, at a detailed level, analysts and, at a more general level, banks' managements (and the supervisory authorities) to assess the bank's exposure in a number of different ways. For instance, it might be desirable to be able to distinguish between claims on sovereign borrowers, banks and others.

Claims should be recorded irrespective of currency. For banks which conduct retail business in other countries through local offices, however, intra-country loans denominated in the local currency will be subject to country risk in a somewhat different sense

since 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 exposure total.

Offsets of deposits against credits may be possible, but probably quite limited in practice. Deposits from a country should not ordinarily be offset against credits to that country unless the bank has established a legal right of set-off vis-à-vis the same customer. Even then, it should be borne in mind that legal actions by third parties may prevent the bank from enforcing its right of set-off.

Certain potential claims that do not appear on the balance sheet can also involve country risk and banks should seek to identify their true exposure in this regard. For example, letters of credit and legally binding commitments to lend to foreign clients may expose the bank in much the same way as a loan that has actually been drawn down. Banks should monitor all commitments to provide funds whatever their precise nature may be. Such commitments may arise from loans with draw-down according to a schedule and even from market lines whose total may not have been advised to the potential borrower. The bank should also take into account any guarantees it may have issued in favour of borrowers abroad and any "buying risk" it may have taken on in the form of acceptances or "a forfait" paper. Certain banks also include some proportion of their forward foreign exchange contracts in their measurement of country exposure. Fiduciary operations, where the bank acts only as an agent, need not be regarded as country exposure, although a bank should be aware that operations of this sort can, in certain circumstances, expose the bank.

III. The control of country exposure

Having assessed the nature of country risk for individual countries and measured the individual country exposures, a bank then needs to reach a view on the appropriate weighting or actual limits to be applied to its individual country exposures. This process should take account of the size and nature of the bank itself, the perceived economic strength and stability of the borrowing country and the bank's spread of risk or existing portfolio diversification.

An individual bank, even though it may engage in the most sophisticated and informed country risk analyses, can have little direct influence on the country risks which may confront it in its international credit operations. A bank is, however, able to spread its risks by diversifying its country exposure in the same way as it tries to avoid excessive concentrations of risk in any of its areas of business. In recommending diversification, however, the Committee recognises that many banks have particular expertise in a given area and it accepts that such expertise may justify extra concentration of risk in that area. Furthermore, diversification pursued for its own sake may also add to rather than reduce risk. A somewhat similar qualification can be made in the case of a consortium bank with first-class shareholders that wish to use it as a vehicle to channel lending to a particular country or

region. But in such cases the exposure of a consortium bank should be taken into account by its shareholders in assessing their own exposure and the special risks attaching to such exposures recognised by the shareholders in the context of their overall commitment to that consortium bank.

Any system for control of country exposure should be based on the setting and monitoring of country exposure limits. All banks should have a system for establishing, maintaining and reviewing country limits. Overall exposure limits for each country to which the bank extends or is considering extending credit should be set on prudential grounds and not on marketing grounds. To achieve the necessary objectivity, it is important that banks maintain a correct division of responsibility by separating the marketing function from the limit-setting function. In any case, limits should be set in a formal process that culminates at a very senior level in the bank (for example, with the bank's directors or with a senior policy committee) which enables the process to be integrated at the highest level with the direction of the bank's international credit operations.

Banks should set limits on their country exposure in relation to degrees of perceived risk. The limits banks set should be related to their capital and reserves, i.e. to their capacity to sustain losses in their business and should apply both with and without risk reallocation as referred to in section II(a) of this paper. As one check on its degree of concentration, a bank will wish to relate its country exposure pattern to the total foreign indebtedness of countries and to the overall exposure of international banks. A help in this exercise is the BIS's semi-annual report on the maturity distribution of international bank lending.

In recognition of the differences in country risk that may be present in different types of lending, it may often be sensible for banks to set out to diversify their exposure within major borrowing countries by placing sub-limits on certain types of credit (i.e. trade-related credits, self-liquidating loans, project loans, co-financed loans, etc.), by type of borrower (banks, sovereign borrowers, etc.) or by maturity (short-term and long-term). Also, although not directly related to country risk, there are single borrower limits in most countries, either statutory or self-imposed, and similar limits should of course apply to international borrowers.

Once limits have been set, they should not be breached without going through procedural safeguards, such as referral to the board or the policy-making group which originally approved them, even if this means abstaining from making loans which promise a good return or which fulfil other marketing objectives. At the same time, limits set on prudential grounds ought not to be considered as targets by the marketing divisions of the bank. In practice, this may be difficult to avoid unless lending officers themselves have a perception of country risk and of their bank's policy in that respect.

Banks' procedures must provide for the regular review of country limits so that these may be raised or lowered in response to changing risks. Since essential support to the limit-setting process comes from the bank's country exposure reporting and country risk assessment systems, regular reviews must entail updates on country risk perceptions and the systematic comparison of exposure and limits. This will help banks to anticipate problems that may arise in countries where they have substantial exposure and enable them to take a cautious attitude to new high-risk countries.

Should problems arise with existing credits, banks will need to reconsider the nature and extent of their exposure, which might include working out new arrangements with borrowers. Such action will always need to be considered with due regard for the overall circumstances. Provisions should be made against expected losses and losses should be written off as appropriate. Where an interruption of interest or principal payments is due to country risk factors, the borrowing country may apply to its creditors for a rescheduling of its debts. In such cases, even when arrangements satisfactory to both sides have been worked out, the bank should not assume that losses may not ultimately result. Indeed, the fact of rescheduling may frequently be thought to indicate a deterioration of creditworthiness and banks should be ready to make appropriate provisions to capital against probable losses.

IV. The role of the banking supervisor

In the same way that the supervisor would not expect to dictate to banks what specific domestic loans should be granted, he does not set out to dictate to banks decisions about specific international loans. Bank managements are responsible for the risks involved in the credits that they grant, whether to domestic or international customers. At the same time, however, the supervisor has a responsibility to review risks, particularly country risks, and needs, therefore, to ensure that banks have adequate methods of assessing, measuring and controlling their country exposure.

In the first place, the supervisor will wish to see that banks operate at least some form of country risk assessment system, that that system has sufficient resources devoted to it and that it is competently managed. He should be ready to suggest improvements in banks' systems where he believes that his advice would be of benefit.

Secondly, the supervisor will take an interest in banks' country exposure management. Not only will he wish to see that banks have systems that capture the totality of their country exposures in a manner sufficiently detailed to permit adequate control, but he will wish to see adequate diversification of each bank's exposure. He will therefore need to know about individual country exposures and may comment on them in the light of the bank's capacity to sustain losses. One of the main difficulties facing the supervisor is to judge the true extent of a bank's country exposure, since large differences among banks' measurement systems may make comparisons difficult or impossible. Partly for this reason, standard

reporting for at least summary country exposure data has been introduced in several countries. Such reporting allows the supervisor (as well as the banks themselves, when these reports are aggregated and publicised) to compare in a standard way country concentration of lending and lending in relation to capital.

Thirdly, the supervisor will be concerned to see that banks use their country risk assessments to set and maintain continuous controls on their own exposure. He may also wish to ensure that banks have some form of self-imposed limits on their exposure and that those limits function effectively to contain and to diversify their exposure.

Finally, the supervisor will wish to satisfy himself that banks for their guidance have access to the best possible macro-economic statistics. The Committee is well aware of the deficiencies in international debt statistics and is currently pressing for improvements in their consistency, coverage and timeliness. Banks can significantly contribute to the value of international statistics by making their own returns as promptly and as accurately as possible.

DEFINITIONS AND CONCEPTS

Country risk is taken to refer to the possibility that sovereign borrowers of a particular country may be unable or unwilling, and other borrowers unable, to fulfil their foreign obligations for reasons beyond the usual risks which arise in relation to all lending.

Country risk assessment, following on from the above, refers to the methods used (by lending banks in particular) to evaluate the risk of an interruption in the servicing or repayment of obligations by borrowers of a particular country.

Country exposure is taken to refer to an individual bank's or banking group's exposure in its total claims on borrowers 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 from that of the borrower.

Country indebtedness is taken to refer, in an international context, to the sum total of external borrowing by a particular country from all sources.

Sovereign risk arises from the special risk associated with a sovereign loan, which is a loan to, or guaranteed by, a government (and some government-guaranteed bodies). The special significance of such lending lies in the risk that it might prove impossible to secure redress through legal action, i.e. the borrower might claim immunity from process or might not abide by a judgement.