Guidelines
for the Management of Country Risk

Swiss Bankers Association

Contents

Introduction

Every bank with cross-border (foreign) business has to identify, record, assess, limit and if necessary make value adjustments for its own exposure to risks.

The aim of these Guidelines is to help banks in setting up their internal structures, policies and procedures for the management of country risk. In no way are they intended to standardise the risk management function at the banks, which are free to implement the Guidelines as they see fit so long as the Guidelines' minimum requirements are met. Basically, the methods and systems should follow the principle of "best practice" and be appropriate to the size and significance of the foreign exposure in question. The methods employed and the degree of detail incorporated into internal directives should be commensurate with the volume and type of exposure, i.e. must be adequate for the risks.

The Guidelines apply to all banks reporting to the Federal Banking Commission as supervisory body. For Swiss bank groups with domestic and foreign branches and subsidiaries, these Guidelines must be implemented both at the level of the individual institution and group-wide (consolidated).

If the management and control of foreign exposure fail to meet the requirements of the Guidelines, internal structures and procedures must be adjusted to assure compliance; otherwise the activity in question should be scaled back or abandoned altogether.

I Country Risk

Country risk arises from changes in the value of foreign exposure due to country-specific political and economic conditions. It consists of transfer risk and "other country risks".

- Transfer risk means the risk to the repatriation of foreign claims as a result of restrictions over the free flow of money and capital, or of other economic or political factors.
- "Other country risks" consists of the part of the foreign exposure position whose value depends on the economic and political risk factors prevailing for the country concerned, independent of the transfer risk or credit risk (individual counterparty risk); these factors include in particular the country-specific liquidity, market and correlation risks.

Country exposure is understood as total exposure abroad of every kind, including contingent liabilities, irrevocable credit lines, and derivative instruments, irrespective of whether they are posted to the banking book or the trading book.

Country risk positions are recorded by risk domicile rather than the domicile of the debtor. The risk domicile of secured exposure must be assessed by examining the collateral. For the definition of the risk domicile the principles of Art. 21e/2–4 of the Banking Ordinance apply.

Comments:

While classical cross-border loans in foreign currency were the dominant feature of the 1970s and 80s, this was followed by rapid growth in the securities and derivative instruments businesses. The partial dependence of these businesses on local economic and market conditions as well as the possibility of refinancing them in local currency has led to the increasing importance of "other country risks".

"Other country risks" particularly the "country liquidity risk", could best be described as a country-specific risk associated with large concentrations of exposure or "correlation risk" ("Klumpenrisiko") analogous to the risk of excessive exposure to a single industry. With regard to foreign claims, the assessment of this risk is often an integral part of the counterparty rating system. In the case of market risk, the country-specific correlation risk must be considered using risk measurement and aggregation techniques.

Essentially, all foreign exposure includes elements of "other country risks", while the currency of denomination and the type of refinancing determine whether a transfer risk exists or not. Thus, foreign exposure which is denominated and refinanced in the local (foreign) currency will generally be subject solely to the "other country risks". Foreign claims *denominated in a currency other than the domestic currency of the debtor will include transfer risk, unless it can reasonably be ascertained and documented that the risk could be transferred.*

Exposure recorded in the trading book is not exempt from the Guidelines. However, with regard to provisioning, this exposure might be managed differently, as well as treated differently, than positions in the banking book. Insofar as the management of market risk (interest, forex, equity) is organised by country, it should be considered as part of the country risk management system. Besides the present Guidelines, the "Risk Management Guidelines for Trading and for the Use of Derivatives" of 31 January 1996 apply.

II Risk Policy

1. Content

The risk policy includes, aside from the strategy developed for assuming country risks, the principles for the recording (identification and measurement), management and control of country risk, as well as for the organisational structures.

2. Responsibility

Top management is responsible for the risk policy in respect of country risk, i.e. the board of directors in the case of a company limited by shares. The senior management (executive board, group executive board, etc.) formulates the risk policy, which is to be approved and periodically assessed for its suitability by the board of directors. Senior management issues instructions for the implementation of the risk policy and delegates authority for the assumption of risks. Adherence to these regulations is to be monitored.

3. Minimum Requirements

Country risk must be identified, measured, assessed, limited and controlled by all banks. The scope, degree of detail, and systems and methods must be appropriate to the extent of the business activities and their associated risks. There must be an adequate internal control system.

Comments:

Questions of risk management, and in particular key decisions on risk policy and its periodic review, are among the fundamental leadership tasks.

Persons who are entrusted with daily risk management and control tasks must possess the necessary qualifications.

The minimum requirements for the risk policy pursued (according to II/3), which will be discussed in more detail in the following paragraphs, only constitute an outline of what must be accomplished by the banks' own structures and processes. Basically, an adequate system of country risk management must be put in place, a system designed to provide the management and control functions with a sufficiently high standard of precision given the level of country exposure.

III Recording (Identification and Measurement)

1. Risk Identification, Measurement, Assessment

Each bank must be in a position to identify country risk exposure and monitor the performance of these positions. The assessment of country risk should be uniform within a bank and be appropriate to the size of the exposure. The basis for this could be the bank's own country risk analyses (e.g. including classification into rating categories) or accepted externally available country assessments.

Banks with considerable foreign exposure and considerable country risk have to periodically review the influence of potential credit deterioration, or payment problems of specific countries or groups of countries, on their balance sheet and P&L performance. The findings must be brought to the attention of the senior management officers responsible.

2. Appropriate Documentation

Foreign exposure, risk assessments and, where necessary, the results of periodic stress tests should be appropriately documented.

Comments:

Risk identification and measurement means in the first instance that the size of the exposure per country can be adequately determined. Furthermore, the risk on this exposure must be determined on the basis of internal or external rating systems. Banks with substantial foreign exposure can be expected to provide quantitative estimates of potential losses in the event of default and to ascertain the probability of default on a portfolio basis, while simple assessments of the probability of loss and the potential loss on default on a country-by-country basis will be sufficient for banks with little foreign exposure.

In-house country ratings, particularly those produced by banks with extensive foreign exposure, often reflect a very good knowledge of the countries studied. However, where there are significant differences between the internal and externally available ratings, a clarification of the differences is indispensable, both as a quality control measure and to avoid conflicts of interest within the bank.

Banks with exposure in developing countries and emerging markets have to simulate the effects of extreme credit deterioration by conducting stress tests, if the risk exposure is substantial in relation to their equity base and P&L.

IV Risk Limitation and Provisions

1. Limit System

Banks with foreign exposure must have an adequate limit system in place for country risk. The limits must be regularly reviewed and authorised by the senior management function designated for that purpose.

2. Internal Control System

The banks are obliged to have adequate information systems to monitor compliance with country risk limits. It must be possible to detect a limit violation in good time and this should result in a report to higher authorities. The employees who are entrusted with the controlling function must have the required knowledge and must be sufficiently independent from the staff whose work they are assigned to monitor.

3. Valuation and Provisions

The banks make adequate value adjustments, on the basis of their own valuation principles (it being understood that these principles must be compatible with official regulations). Country risk, value adjustments and provisions must be recorded in such a way that they can easily be reviewed by the auditors.

In addition, banks decide for themselves on their own provisioning against future unexpected losses on the basis of their internal risk models and, of course, within the scope of the current accounting rules (e.g. reserves for cyclical fluctuations).

Comments:

The rapid pace of change in the international political and economic environment make it essential to subject the adequacy of the country limits to regular review. And checks must be made on a daily basis to assure that *country limits are not violated. Rules have to be defined for limit excesses as well as rules for approving excesses.*

Differences can appear in valuation and provisioning of operations in the banking book as compared to the trading book. In both cases, however, the benefits of diversification can be taken into account when deciding on provisioning (for unexpected losses).

Value adjustments that go beyond the amount necessary are considered hidden reserves. They are not allowed in group accounting (consolidated accounts). In the accounts of a single entity (company, autonomous division) they are to be shown under "other provisions".

Additional provisioning in the form of "reserves for cyclical fluctuations" can be made if the preconditions laid down in the RRV (Bank Accounting Guidelines) are fulfilled.

V Reporting and Disclosure

1. Reporting

Country risk exposure as well as comments on large differences between the bank's own ratings and externally available country assessments must be part of the bank's risk reporting. This reporting must also include regular country risk reports, no later than the end of each reporting period, to the board of directors or other corporate authority determined by the board of directors. Extraordinary changes must be reported immediately.

2. Disclosure

The foreign exposure (countries grouped by risk class) must be published in the annual report, if this is important for assessing the asset value and quality of earnings of the bank. The rating system used must be explained. The use of international standards as a guideline is recommended.

Comments:

Foreign exposure based on risk domicile and grouped by country rating must be disclosed in the appendix (notes) to the annual report, along with explanations of the country rating applied. This disclosure, which is organised by risk domicile, must not be confused with the reporting organised by the debtors' domicile (Table J).

VI Audit

1. Internal Audit

The internal audit function will particularly check the risk policy, risk management and control of country risk for compliance.

2. External Audit

The statutory auditors examine whether these Guidelines have been adhered to, basing their work as far as is both possible and useful on the work of the internal audit function. They record the audit results in the ordinary audit report (to the Federal Banking Commission).

VII Effective Date/Transition Period

The Guidelines were approved by the Board of Directors of the Swiss Bankers Association on 4 September 1997, taking effect from 31 December 1997. There will be a transitional period until 31 December 1999, during which the current Federal Banking Commission regulations on minimum provisions for country risk (EBK-RS 92/4) can be applied.

Basle, November 1997

SWISS BANKERS ASSOCIATION