IBF response to the Central Bank of Ireland Consultation on Proposed Policy on the management of Country Risk by Credit Institutions - CP 66

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1. Introduction

The Irish Banking Federation (IBF) is the principal voice of the banking and financial services sector in Ireland, representing some 50 member institutions including licensed domestic and foreign banks operating in the financial marketplace. As the key point of contact on industry matters for policy makers, IBF provides representational leadership for our membership – retail and international banks in Ireland – through the development of solutions that meet the changing needs of the marketplace.

We are pleased to provide comments on the Central Bank of Ireland consultation paper regarding 'Proposed Policy on the management of Country Risk by Credit Institutions' – CP 66. The management of country risk[1] by credit institutions is an important aspect of a financial institution's operations and thus it is appropriate that related guidelines are established.

The Basel Committee introduced their Core Principles for Effective Banking Supervision in 2012 and it is important that the Irish banking industry is in compliance with these international principles. Principle 21 refers to country and transfer risks and states that the supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate country risk and transfer risk in their international lending and investment activities on a timely basis.

The country risk policy and related procedures of IBF members are akin to the standards required by this consultation paper and many aspects of this consultation paper are covered by existing Credit Policy within financial institutions operating in Ireland.

[1] Country Risk as defined in the consultation paper is 'the risk of exposure to loss caused by events in a foreign country' and includes sovereign, transfer and contagion risk.

2. General Comments

We are largely in agreement with the content of this consultation paper. As stated in the paper the main purpose is to 'formalise requirements in an area that is already subject to evaluation as part of the ICAAP and the Supervisory Review and Evaluation Process'.

It would be useful if the consultation paper distinguished more clearly between country and sovereign ratings. For the most part, sovereign ratings act as a good proxy for country ratings, especially for a portfolio such as non-Emerging markets. In general the need for specific Country Risk ratings should be determined by the make-up of an institution's portfolio. In this regard, use should be made of the OECD's Country Risk classification which is designed to reflect transfer and convertibility risk and cases of force majeure. The need for separate country ratings (as well as sovereign ratings) should be determined by the percentage of a credit institutions exposure which falls within the higher risk classifications (primarily emerging markets).

Further clarity on provisioning at a country level is required as provisioning is currently managed at customer level using credit rating data, together with an institution wide general provisioning methodology based on historic / expected future portfolio performance. It is not fully clear if the consultation paper recommends making a specific country risk provision or whether it recommends that Country Risk should be taken into account when making provisions generally. Expected–Loss based General Loan Loss Provisions (GLLPs) comply with IFRS if country specific risk is already included in PD parameters. Since rating tools in certain Groups take country ceiling effects into account, compliance with IFRS is confirmed. Moreover, Sovereign ceiling effects will also impact on Specific Loan Loss Provisions (SLLPs). We would view that this type of Country Risk provisioning be deemed sufficient under any Country Risk Policy.

2.1.1 Other observations

- Section 3.9 states that credit institutions should conduct stress-testing analysis of their Country Risk exposures in order to monitor actual and potential risks. If an element of a portfolio is considered immaterial, i.e. < 1% of your total portfolio, it can usually be excluded from stress testing. Is this the case here?

- The paper makes reference to country visits which in the some cases are very limited, if at all, in line with materiality of international exposures.
- We agree that credit institutions should have a clearly defined Country Risk policy approved and implemented by senior management in place?
- We also agree that the details in the policy, and any procedures drawn up in respect of them should be 'reflective of the size and complexity of a credit institution's international lending and investment activities'.
- The list of requirements in section 3.2.3 is quite wide and prescriptive.

2.2 Proportionality

Under section 2, Supervisory Approach, we note that the Central Bank of Ireland will ensure to take account of the size and complexity of a credit institution's international lending and investment activities and other factors set out in this policy in considering whether the credit institution has appropriate systems to control Country Risk and maintains adequate provisions for such risk.

Further clarity as to how the proportionality principle will apply should be set out i.e. will it be based on the overall size of an institution, systemic importance or level of multi-country exposure? Or will the Central Bank accept that not all of the requirements of this policy will be adopted by smaller non-systemically important institutions where other mitigating mechanisms and controls are applied?

The consultation paper states that country limits need to be approved annually by the Board. Currently country limits in some subsidiaries are approved by the Group Risk Committee which is deemed to be the appropriate level for such approval. Some flexibility in this area for subsidiaries should be included to reflect the practicalities of this since the paper itself makes it clear that Country Risk must be managed centrally.

Proportionality is an important aspect which needs to be carefully considered. For a subsidiary of an international parent the Country Risk policy sits with the Group Country Risk policy.

3. For a subsidiary of a European or International Bank operating in Ireland

For subsidiaries of international and European banks operating in Ireland, the approach to the management of Country Risk is determined and ultimately governed at Group level, albeit that the risks outlined (see section 1.3 of the consultation paper) are taken into account and assessed locally. A Group Country Risk Manual is usually in place and clearly outlines the way Country Risk is defined, analyzed, used and monitored within the Group.

One aspect of the consultation document which could be reconsidered is the limited reference to International Bank's operating in Ireland and the Central Bank of Ireland's expectation on the roles of a subsidiary in managing Country Risk, whose approach to the management of Country Risk and its appetite is aligned at Group level. Most aspects of the policy will apply, however compliance to certain parts of the policy is not feasible for subsidiaries operating in Ireland and would undermine the overall management and appetite managed at Group level, for example:

Section 3.1.4: - "Country Risk must be managed on a centralised basis and integrated with a credit institution's overall credit risk management."

Section 3.2.3: - "The details to be included in the policy, and any procedures drawn up in respect of them, should be reflective of the size and complexity of a credit institution's international lending and investment activities. The policy should set out the credit institution's business strategy in relation to international lending and investment activities, its risk appetite and risk tolerances. The policy should include: Country Risk appetite and the limits for international exposures."

A number of the items outlined under section 3.2.3 state that "The policy should include:" which are not considered policy items and should only be referenced. These items should in theory be clearly outlined in process documents or credit policies rather than outlined in a Country Risk policy document, for example:

Section 3.2.3:

- "types of and criteria for acceptable collateral and guarantees, financial instruments and hedging strategies (e.g. credit derivatives or netting arrangements) which are permissible for the mitigation of Country Risk"
- "the minimum standard terms and conditions to be incorporated in loan documentation in accordance with the legal requirements of each country; the process in place for evaluating the legitimacy of documentation and perfection of collateral"
- "procedures for dealing with deteriorating situations in a country, including contingency plans and exit strategies"

No reference is made within the document to how the policy will apply when a bank has been granted a related party exemption for exposures to a subsidiaries parent company within a foreign jurisdiction.

Some subsidiaries within Group frameworks leverage off Group resources and as a result the financial institution benefits from centralised expertise and economies of scales, with the Group obtaining an overall view of the risks it faces rather than a narrow view at a local level.

Implementation of the policy in its current format may result in a significant duplication of roles, which in some instances are already carried out at Group level and ultimately could place an additional unnecessary cost on an International subsidiary.

Setting absolute limits at a country level is not considered practical as some institutions sets limits based on other criteria e.g. industry concentration, company profile, country concentration as a percentage of the portfolio / balance sheet as a whole. If absolute country limits must be set would a buffer be acceptable to allow for currency / other fluctuations?

Will institutions be required to make their own assessment of Country Risk and related country provisioning requirements or does this policy tie into counter-cyclical buffer requirements which we understand will be set by competent authorities in each country?

In summary, the management of Country Risk as a subsidiary entity is not fully taken into account or referenced within this consultation paper. A separate section specifically detailing the expectations of how a subsidiary operating in Ireland manages Country Risk is required, taking into account management of Country Risk Management that is carried out at a Group level.

4. Follow up

Please contact me if you would like to discuss our response in further detail.