



Banc Ceannais na hÉireann  
Central Bank of Ireland

Eurosystem

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# Policy on the Management of Country Risk by Credit Institutions



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## **1. Introduction and Application**

This Policy on Country Risk (“the Policy”) sets out the requirements and supervisory perspective of the Central Bank of Ireland (“the Central Bank”) with regard to ensuring that credit institutions have adequate policies and processes in place to identify, measure, evaluate, monitor, report and control or mitigate Country Risk in their lending and investment activities on a timely basis.

The Central Bank deems it necessary to introduce this Policy in order to enhance the sound prudential regulation and supervision of banks and to have appropriate oversight of some of the risks associated with banks’ international lending. This facilitates our ability to comply with international best practise i.e. the Basel Core Principles for Effective Banking Supervision 2012.

### **1.1 Application of this Policy**

This Policy applies to all licensed banks and building societies (subsequently referred to as “credit institutions”) regulated by the Central Bank, including foreign subsidiaries of Irish credit institutions on consolidation. The Board of each credit institution is required, on an annual basis, to satisfy itself as to the applicability of this policy in the context of its international lending and investment activities. EEA Branches operating in the State fall outside the remit of this Policy.

For subsidiaries of international banking groups authorised in Ireland the Central Bank recognises that some elements of Country Risk management may be carried out at a group level. In these instances, the Central Bank would expect the Board of the subsidiary to review the Group Country Risk policies and limits at least annually and, if it is satisfied that these are appropriate and meet the requirements set out in this document, endorse them for the local institution. If the Board deems that Group policies and processes are not appropriate for the subsidiary or do not meet the requirements as set out in this Policy, they cannot be endorsed by the Board of the subsidiary. In such instances the subsidiary will

be required to develop local policy, limits and processes for Country Risk. The utilisation of local Country Risk limits must be reported periodically to the Board (or Board Risk Committee) of the subsidiary.

### 1.2 Legal Basis

The requirements placed on credit institutions arising from this Policy are imposed by the Central Bank, as conditions to which all credit institutions are subject, pursuant to Section 10 of the Central Bank Act, 1971, and Section 17 of the Building Societies Act, 1989.

### 1.3 Definitions

Country Risk is the risk of exposure to loss caused by events in a foreign country. The concept is broader than Sovereign Risk, which is a sub-set of Country Risk, as all forms of lending or investment activity whether to/with individuals, corporates, banks or governments are covered. It includes on and off Balance Sheet exposures.

The main categories of Country Risk comprise Sovereign, Transfer and Contagion Risk:

- Sovereign Risk is the risk that a foreign government may not have the capacity or willingness to repay its direct and indirect (i.e. guaranteed) foreign currency obligations;
- Transfer Risk is the risk that a borrower may not be able to convert local currency into foreign exchange and so may be unable to make debt service payments in foreign currency. The risk normally arises due to exchange restrictions imposed by the government in the borrower's country;
- Contagion Risk is the risk that developments in one country lead to a downgrade or adverse credit conditions not only for that country but also other countries in its region.

Other categories of Country Risk include:

- Currency Risk – this is the risk that a borrower’s holdings of domestic cash and income streams become inadequate to service its foreign currency obligations due to a devaluation of the domestic currency;
- Indirect Country Risk – the risk that the repayment ability of a domestic borrower is adversely affected by developments in a foreign country where the borrower has business interests; and
- Macroeconomic Risk – the risk that a borrower in a foreign country may suffer from economic policies of the government in that foreign country, e.g. higher interest rates or taxes, which adversely affects its repayment ability.

## **2. Supervisory Approach**

In determining its supervisory approach, the Central Bank will have regard to the Basel Committee’s Core Principles for Effective Banking Supervision. In addition, the Central Bank will have regard to 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.

In reviewing the effectiveness of a credit institution’s Country Risk management and the adequacy of provisions made, the Central Bank will:

- determine whether a credit institution’s policies and processes give due regard to the identification, measurement, evaluation, monitoring, reporting and control or mitigation of Country Risk. The Central Bank will also determine if the policies and processes are consistent with the risk profile, systemic importance and risk appetite of the credit institution, taking into account market and macroeconomic conditions and provide a comprehensive bank-wide view of Country Risk exposure. Exposures (including, where relevant, intra-group exposures) should be identified,

monitored and managed on a regional and an individual country basis (in addition to the end-borrower/end-counterparty basis). Credit institutions are required to monitor and evaluate developments in Country Risk and take appropriate mitigating action when necessary.

- determine whether a credit institution's strategies, policies and processes for the management of Country Risks have been approved by the credit institution's Board on an annual basis and that the Board oversees management in a way that ensures that these policies and processes are implemented effectively and fully integrated into the credit institution's overall risk management process.
- determine whether credit institutions have information systems, risk management systems and internal control systems that accurately aggregate, monitor and report country exposures on a timely basis; and ensure adherence to established country exposure limits.
- review the adequacy of provisioning by credit institutions against Country Risk (see subsection 3.11).
- require credit institutions to conduct stress test scenarios and to include appropriate scenarios into their stress testing programmes for risk management purposes to reflect Country Risk analysis.
- regularly obtain and review management information on a timely basis on the Country Risk of credit institutions. The Central Bank will obtain additional information, as needed (e.g. in crisis situations).

### **3 Responsibilities of Credit Institutions**

#### **3.1 Role of the Board and Senior Management**

3.1.1 Effective oversight by a credit institution's Board of Directors and senior management is essential to ensuring that Country Risk is managed satisfactorily.

3.1.2 There should be procedures in place for the approval of a credit institution's Country Risk management policy (see subsection 3.2 below) and for ensuring that

senior management implements appropriate measures to identify, monitor and control Country Risk in accordance with the policy.

3.1.3 The Board (or the Board Risk Committee) should review Country Risk exposures on a quarterly basis, or more frequently if required. Any significant changes in the conditions of a country in which the credit institution has substantial exposures, should be reported to the Board (or the Board Risk Committee) on a timely basis.

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

### **3.2 Policy and Procedures**

3.2.1 Credit institutions should have a clearly defined policy, approved by the Board and implemented by senior management, for Country Risk management and provisioning. The policy should be reviewed at least annually by the Board to determine whether it remains appropriate.

3.2.2 The policy may be subsidiary to, or form a part of, a credit institution's overall credit policy.

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. Credit institutions should consider including the following in their Country Risk policy<sup>1</sup>:

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<sup>1</sup> Where a credit institution has not included one or more of the items in this list in its policy, it must be in a position to demonstrate to the satisfaction of the Central Bank that it has considered its inclusion and concluded that this item(s) is not appropriate to its business.

- Country Risk appetite and the limits for international exposures (see subsection 3.7 below);
- clear lines of authority for approval of international lending and investments;
- types of Country Risk which may be incurred by the credit institution (see subsection 1.3 above) and the policies and procedures for managing them;
- the standards and criteria which the credit institution 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 credit institution's existing loan classification system;
- the methodology to be used in measuring Country Risk exposures;
- the Country Risk provisioning policy and methodology (see subsection 3.11 below);
- clear lines of authority for approval of exceptions to policy and the limits allowable for exceptions;
- reporting of exceptions;
- 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; and
- types of management reports on Country Risk.



**3.3 Lending Principles**

3.3.1 Credit institutions should ensure that international lending and investments are subject to the same basic prudent credit granting criteria which are applied to domestic lending and investments.

3.3.2 Credit institutions should be cognisant that countries in which they are lending and investing may be undergoing a process of economic development and restructuring. In such countries, the infrastructure of commercial laws and regulations may not develop at the same pace. In some larger countries, there may be a lack of uniformity in laws and regulations and the interpretation of central directives by regional governments. Credit institutions should not assume that the same laws and regulations are in place in all regions. When required, credit institutions should seek advice from external counsel.

3.3.3 When accepting collateral relating to international lending, credit institutions should confirm that there has been full compliance with statutory procedures in the jurisdiction in question. As such, credit institutions should engage local legal counsel to confirm the legitimacy and enforceability of loan agreements, guarantees and other documentation.

**3.4 Country Risk Analysis**

3.4.1 Credit institutions with significant international exposures should have appropriate systems for monitoring economic, social and political developments in the countries to which they have exposures. Credit institutions need to consider both quantitative and qualitative factors when assessing the risks associated with a particular country.

3.4.2 The quantitative factors which credit institutions should take into account include the size and maturity of exposures along with economic factors for each relevant country, e.g. exchange rate, interest rate, public debt level, GDP and other relevant statistics

3.4.3 Factors used in qualitative assessments of Country Risk may include social and political stability and the legal and regulatory environment of the country. Credit institutions should also have regard to the country's compliance with international standards and codes.

3.4.4 Additional attention is required in relation to business dealings and transactions with counterparties from countries that do not sufficiently comply with international standards.

3.4.5 Credit institutions should be aware of the impact of changes in government strategy and policies. This is particularly important if credit institutions 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 adversely impact the repayment ability of borrowers in that sector or region. Credit institutions should therefore monitor the economic policy in the countries in which they do business.

3.4.6 Credit institutions should not rely entirely on external assessment in relation to Country Risk and should develop an appropriate internal assessment methodology in relation to countries where they have significant exposures.

3.4.7 In times of instability or crisis, credit institutions should consider taking appropriate actions, such as updating analyses more frequently and expanding the scope of Country Risk analysis.

3.4.8 Credit institutions should maintain formal Country Risk analysis files.

3.4.9 Credit institutions should consider including the following in their Country Risk files<sup>2</sup> :

- analysis of political, economic and social issues of the country;
- reports submitted by country managers and credit officers;
- reports from visits to the country;
- reports from outside economic research services and rating agencies;
- published economic data and analysis; and
- copies of documentation approving limits and exceptions to limits.

3.4.10 The results of Country Risk analysis should be integrated with the process of approving credits, assigning country ratings (see subsection 3.5 below), setting country exposure limits (see subsection 3.6 below) and provisioning.

### **3.5 Country Risk Ratings**

3.5.1 Credit institutions that have significant international exposures, should establish a formal Country Risk rating system. Detailed policies and procedures for analysing and approving country credit risk ratings should be developed. The sophistication of such systems should be consistent with the size and complexity of a credit institution's international exposures.

3.5.2 Credit institutions should, at a minimum, take the following into consideration in developing their Country Risk rating systems:

- Country Risk ratings should be assigned at least annually to every country (in particular for countries in emerging markets) where credit institutions have substantial exposures. Interim reviews should be carried out when developments in a particular country warrant such reviews;
- credit risk ratings should be approved independently of business units;

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<sup>2</sup> Where a credit institution has not included one or more of the items in this list in its files, it must be in a position to demonstrate to the satisfaction of the Central Bank that it has considered its inclusion and concluded that this item(s) is not appropriate to its business.

- credit institutions should integrate the Country Risk rating system with their loan classification framework. For example, if a credit institution assigns an unfavourable rating to a country, it will need to consider whether to downgrade all its exposures relating to that country; and
- credit institutions should also use the Country Risk rating system when assessing the appropriate level of provisions.

### 3.6 Country Exposure Limits

3.6.1 Credit institutions should have a system for establishing, maintaining and reviewing country exposure limits. Country exposure limits should be approved annually by the Board. The limits may be revised during the year in response to substantive changes in a country's risk profile.

3.6.2 Exceptions to country exposure limits should be approved by senior management or, depending on the size of the exception, the Board. All exceptions should be reported to the Board on a timely basis.

3.6.3 Country exposure limits must be monitored independently of the business development function.

3.6.4 Credit institutions should ensure that the limits set for international lending are in line with the overall business strategy.

3.6.5 Credit institutions should set exposure limits for individual countries (particularly for countries in emerging markets) to manage and monitor Country Risk. Country exposure limits should apply to all on- and off-balance sheet exposures to foreign borrowers.

3.6.6 In setting limits credit institutions should consider the application of the following sub-limits:

- maturity (e.g. short term and long term);

- type of borrower (e.g. financial institutions, sovereigns and corporates);
- type of Country Risk (e.g. sovereign, transfer, etc.);
- type of product (e.g. trade-related credits, project financing, derivatives and other off-balance sheet exposures, etc.)
- secured and unsecured;
- insured and uninsured;
- industry or economic sector of the borrower; and
- region.

3.6.7 The credit officers and other relevant staff of a credit institution must be made aware of the country exposure limits.

### **3.7 Country Exposure Measurement**

3.7.1 Systems for measuring country exposures need to be commensurate with the size and complexity of individual credit institutions' international lending operations.

3.7.2 Credit institutions should ensure that their systems are sufficiently comprehensive to capture all significant exposures and to permit adequate analysis of different types of risk. Credit institutions' measurement systems, at a minimum, should:

- measure country exposure on a solo and consolidated basis;
- be able to measure different types of exposures (e.g. foreign exchange and interest rate contracts); and
- provide a sufficient breakdown (e.g. by type of borrower, exposure, collateral, maturity, etc.) for analysis by country.

### **3.8 Monitoring and Reporting**

3.8.1 Credit institutions should consider carrying out regular country visits, including visits to their foreign branches and subsidiaries, and maintain direct

contacts with authorities in relevant countries. The frequency of such visits should be determined by the materiality of the Country Risk exposure.

3.8.2 Credit institutions should perform frequent credit reviews and monitoring of their overseas exposures to identify unusual developments and, if appropriate, initiate necessary actions.

3.8.3 Credit institutions should have an effective system in place to produce management reports which are sufficiently detailed for senior management review and to identify exceptions in a timely manner. All exceptions to set limits must be reported to the Board in a timely manner.

3.8.4 Country Risk Reports containing sufficiently detailed information should be provided to the Board on a quarterly basis, or more frequently if required. Significant changes to a credit institutions Country Risk profile should be reported to the Board on a timely basis.

### **3.9 Stress-testing**

3.9.1 Credit institutions should conduct stress-testing analysis of their Country Risk exposures in order to monitor actual and potential risks.

3.9.2 Such testing should include evaluation of the impact on a credit institution's assets and liabilities should various potential Country Risk events occur.

3.9.3 It should also include a correlation analysis to detect or cater for contagion risk, particularly for countries in the same region, or with strong political or economic ties.

3.9.4 Results of stress-testing should be reported to the Board on a regular basis.

### **3.10 Staffing and Organisation**

3.10.1 Credit institutions should dedicate adequate resources to the Country Risk management process, taking into account the extent of their involvement in international lending.

3.10.2 Credit institutions should ensure the staff responsible for the function have the necessary experience and expertise.

3.10.3 Responsibility for Country Risk may be assigned either to a senior executive (e.g. a Country Risk Officer) or to an appropriate committee. Credit institutions may also establish a specialised unit or department to analyse Country Risk (see subsection 3.4 above), propose country exposure limits and carry out regular country reviews.

3.10.4 The function responsible for analysing Country Risk, setting limits and monitoring the credit institution's Country Risk exposures must be independent of the business development function.

### **3.11 Provisioning Policy and Approach**

3.11.1 Country Risk provisions refer to provisions set aside by credit institutions to absorb likely losses arising from their Country Risk exposures. It is expected that any provision for Country Risk would normally be incorporated with a specific provision rather than being a separate provision.

3.11.2 Credit institutions 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.

3.11.3 Credit institutions should have a process in place for determining an appropriate level of provisions. This should include the following:

- identifying sovereign exposures with current/potential repayment difficulties;
- analysing the nature of those difficulties and the extent of the problems; and
- determining what proportion, at the time of review, of exposures to that country is unlikely to be repaid in full.

3.11.4 Any Country Risk provisions made should be justifiable and properly approved and documented.

3.11.5 Where a credit institution has an internal Country Risk rating system, it should clearly demonstrate how its Country Risk rating system is integrated with its provisioning methodology.

As stated in section 2 above, the Central Bank will review the setting of appropriate provisions against Country Risk. The Central Bank will conduct regular reviews of the level of Country Risk provisions made by individual credit institutions

#### **4. Inclusion in Internal Capital Adequacy Assessment Process (“ICAAP”)**

As part of its ICAAP, a credit institution must determine whether Country Risk constitutes a material risk and, if so, it should consider allocating capital as a mitigation of this risk.

#### **5. Disclosure and Regulatory Reporting**

5.1 Credit institutions should establish systems and procedures to ensure the accuracy of reporting in respect of international exposures and Country Risk provisions.

5.2 Credit institutions will provide copies of Country Risk Management policies to the Central Bank upon request.



5.3 Credit institutions will provide details of Country Risk exposures and Country Risk provisions to the Central Bank on a regular basis. The Central Bank will determine the frequency of reporting for each credit institution based on the significance of the credit institution's Country Risk exposure.

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