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BANK OF MAURITIUS

Guidelines on
Country Risk Management

April 2010

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INTRODUCTION

Cross-border exposures subject banks to country risk, that is the possibility that sovereign borrowers of a particular country may be unable or unwilling, and other borrowers unable to fulfill their foreign obligations for reasons beyond the usual credit risk which arises in relation to all lending. The factors which may prevent borrowers of a given country from fulfilling their foreign obligations are diverse and the risks to which banks in Mauritius may be exposed can 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 to external shocks arising from phenomena like financial crises or global recessions.

PURPOSE

The purpose of this guideline[1] is to require banks to put in place a framework for identifying, measuring and managing country exposures and making provisions thereon. The guideline outlines the minimum requirements that a bank's country risk management system shall contain. However, the level of sophistication of a bank's system shall be commensurate with the size, nature and complexity of its cross-border exposures.

AUTHORITY

This guideline is issued under the authority of Section 100 of the Banking Act 2004 and Section 50 of the Bank of Mauritius Act 2004.

[1] The guideline shall be read in conjunction with all other relevant guidelines issued by the Bank of Mauritius (hereinafter referred to as the Bank), available at http://bom.intnet.mu.

SCOPE OF APPLICATION

The guideline applies to all banks licensed under the Banking Act 2004.

EFFECTIVE DATE

The guideline shall come into effect on 1 October 2010.

STRUCTURE OF THE GUIDELINE

There are four sections in this guideline:

Section I:	Board and Senior Management Responsibilities
Section II:	Country Risk Management System
Section III:	Country Risk Provisioning
Section IV:	Disclosure Requirements

SECTION I: BOARD AND SENIOR MANAGEMENT RESPONSIBILITIES

1. The board of directors (hereinafter referred to as the board) of a bank incorporated in Mauritius has the prime responsibility for ensuring that country risk is managed effectively and efficiently. To this end, the board has the duty to ensure that a proper country risk management system is put in place that shall, at a minimum, cater for the following:

   (i) The establishment of policies and procedures

   The policies and procedures respecting cross-border activities shall clearly translate the bank's strategic goals and risk parameters and be established in line with the minimum requirements contained in this guideline. These policies and procedures which shall be approved by the board, shall, *inter alia,* address the following:

   - The setting up of a strategy for doing business abroad and for identifying major risks in a particular country or region;
   - The definition of clear lines of responsibility and accountability for country risk management decisions with, in the case of international banks, an appropriate balance between headquarters' risk management, local managers and regional management committees.
   - The establishment of assessment, measurement, control and monitoring processes, and exception procedures;
   - The determination of country exposure/risk tolerance limits; and
   - The adequacy of provision for country risk.

   (ii) Periodic review of established policies and procedures

   Appropriate platforms shall be set up to review at regular intervals, the policies and procedures so established in order to evaluate their suitability and consistency with the bank's strategic plans, goals, risk tolerance, strength of capital and management.

(iii) The institution of a Management Information System

A proper Management Information System shall be set up. The system shall be capable of reporting, on a regular and timely basis, on the implementation of established policies and procedures and the monitoring of cross-border exposures. It shall provide all feedback that may be necessary for the board to derive assurance that the country risk management processes are effective.

2. The above-mentioned board responsibilities, in so far as a branch of a foreign bank is concerned, are normally expected to be assumed by the head office or by such locally established body to which such responsibilities may be delegated.

3. While the approval of strategies and policies respecting country risk management shall rest with the board, the formulation of same may be delegated, with the necessary written authority, to sub-committees or appropriate risk management platforms. By and large, any other responsibility delegated by the board to sub-committees shall subsequently be monitored and evaluated for effectiveness on a regular basis.

4. Senior management has the responsibility for

- implementing sound and appropriate policies and procedures for managing country risk and ensuring that same are communicated to relevant persons;
- ensuring the smooth running of the different country risk management processes;
- ensuring that staff allocated to the country risk management system has the required knowledge and expertise to deal effectively with risks inherent to the bank's cross-border activities; and
- handling responsibilities, if any, delegated to it by the board/head office for the effective management of country risk.

SECTION II: COUNTRY RISK MANAGEMENT SYSTEM

ASSESSMENT OF COUNTRY RISK

5. The assessment of country risk involves the determination of the nature of risks associated with individual country exposures and the evaluation of country conditions. In this connexion, banks shall make a thorough evaluation of risks which may be associated with their cross-border operations and which have the potential to adversely affect their risk profile. Listed below are some of those risks which banks shall take on board while managing their international lending portfolio.

- **Transfer risk -** The risk that borrowers in a foreign country may not be able to secure the required foreign exchange to service their external obligations (e.g. due to exchange controls).
- **Sovereign risk -** The likelihood that a foreign government will alter its debt service payments, thereby breaking pre-arranged repayment schedules. It arises as a result of a bank having any type of lending, extension of credit, or advance to a country's government. The significance of such lending lies in the risk that it might prove impossible to seek redress through legal action, viz. the borrower might claim immunity or might not abide by a judgement.
- **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.
- **Contagion risk** - The risk that adverse developments in one country may, for instance, lead to a downgrade of rating or a credit squeeze not only for that country but also for other countries in the region, notwithstanding the fact that those countries may be more creditworthy and that the adverse developments do not apply to them.

6. An effective assessment process presupposes the availability of statistical data from both national and international sources and the required expertise to forecast risks throughout the life of a bank's credit exposure abroad. While judgement forms part of an assessment process, care shall be taken in interpreting information received from local representatives or other persons whose analysis may be influenced by marketing priorities, so that the assessment does not incorporate a sales bias.

7. The following may form the basis of an assessment system:

(i) Banks with cross-border operations shall have robust systems for monitoring economic, social and political developments in the countries in which they have exposures;

(ii) Banks shall consider both quantitative and qualitative factors of countries under assessment. In developing quantitative assessments of the risk of a country, banks may take into account the size, nature and maturity profile of its external borrowing as well as its macro-economic variables;

(iii) Banks may include in their qualitative assessments of country risk the quality of the policy-making function, social and political stability and the legal and regulatory environment of the country;

(iv) Banks shall give special attention to business dealings and transactions with counterparties from countries that do not comply or are poorly compliant with international standards;

(v) Banks may have recourse to a variety of internal and external sources for assessing country risk which may also include their Group country risk management framework where applicable. However, banks have the prime responsibility for assessing country risk and ensuring that the minimum requirements of this guideline are complied with;

(vi) Banks shall be aware of the impact of changes in governmental strategies and policies, particularly in cases where they have substantial credit exposures to a given business sector or region in a country. The reduction or withdrawal of government support to a sector or region or changes in government policies may severely weaken the repayment capacity of borrowers in that sector or region. Banks shall 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 involve a high degree of risk and to adjust their country business strategies in an appropriate and timely manner;

(vii) In times of instability and impending crisis, banks shall consider taking appropriate actions, such as updating their analyses more frequently and expanding the scope of their country risk analysis;

(viii) 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, an independent analysis shall still be needed since the lead bank may well find a particular credit attractive for reasons which may not be shared by other participating banks; and

(ix) Banks shall integrate country risk assessment with the process of formulating marketing strategies, approving credits, assigning country ratings, setting country exposure limits and making provisions.

MEASUREMENT OF COUNTRY EXPOSURES

8. There is no single method for measuring exposures that will suit all banks so that systems for measuring country exposures need to be tailored to the size and complexity of an individual bank's international lending operations. As a general principle, banks shall ensure that the system is comprehensive enough to capture all significant exposures and detailed enough to permit an adequate analysis of the different types of risk. As some counterparties may be more exposed to local country conditions than others, banks may distinguish among different types of exposures, e.g. trade-related, banking sector, public and private sector exposures.

Country Risk Ratings

9. Banks may rely on external ratings issued by eligible External Credit Assessment Institutions (ECAIs)[2]. In cases where countries are not rated by eligible ECAIs, banks may use the consensus risk scores of Export Credit Agencies (ECAs) participating in the "Arrangement on Officially Supported Export Credits", provided the ECAs publish their risk scores and subscribe to the OECD agreed methodology.

Risk Re-allocation

10. The usual practice is to allocate each claim according to the residence of the borrower or the country lodging the placements or the investments. However, legally-binding guarantees from a resident of a country other than that of the borrower may cause the claim to be moved to the country of the guarantor. Similarly, eligible collateral available in a country other than that of the borrower may lead to the re-allocation of a claim to the location of the collateral.

[2] Please refer to the *Guideline on the Recognition and Use of External Credit Assessment Institutions.*

11. For the purpose of country risk provisioning, both the country of direct exposure and the country of ultimate exposure, whichever yields a more favourable level of provisions, would be acceptable.

Exposures of banks

12. Items counting towards exposures of banks cover both on-balance sheet and off-balance sheet exposures. As such, banks shall monitor all commitments to provide funds irrespective of their nature.

13. On-balance sheet exposures normally include loans and advances, investment in shares and securities (except those excluded from total (gross) capital in the capital adequacy ratio computation) and funds in foreign bank accounts including nostro accounts.

14. Off-balance sheet exposures representing potential claims that do not appear on the balance sheet, such as letters of credit, acceptances and legally binding commitments to lend to foreign clients shall be converted into credit equivalents on the basis of conversion factors set out in the *Guideline on Standardised Approach to Credit Risk*.

15. In line with their board-approved policy, banks may further decide whether or not to include exposures of their foreign branches, denominated in the currency of the host country, in exposures subject to cross-border risk.

Fiduciary Operations

16. Fiduciary operations do not involve country exposures per se. However, there is a risk that banks may become liable to their clients on account of such operations. Banks, as safe-keepers of assets entrusted to them, have, therefore, a fiduciary responsibility towards their clients and must, at all times, know the manner in which the assets are invested and where and how the assets are available.

CONTROL OF COUNTRY EXPOSURES

17. Banks shall determine the appropriate limits to be set for individual country exposures. The limits shall, *inter alia*, take into account the capital, size and nature of the bank itself, the perceived economic strength and stability of the borrowing country and the diversification of the banks' international lending and investment portfolios.

18. The determination of country exposure limits shall, at a minimum, be based on the following factors:

    (i) Banks shall set limits on their country exposures in relation to degrees of perceived risk;

    (ii) Overall exposure limits for each country to which a bank extends or is considering extension of credit shall be set on prudential grounds rather than marketing grounds;

    (iii) Limits shall be set in relation to a bank's capital base;

    (iv) Exceptions to country exposure limits shall require the authorisation of the board or such delegated authority;

    (v) Banks shall ensure that the limits set for their cross-border lending are compatible with their overall strategic goals and that they have the necessary resources to administer lending levels at the targets set; and

    (vi) Banks may diversify their exposures within major borrowing countries by placing sub-limits on certain types of credit (e.g. trade-related credits, project financing, derivatives and other off-balance sheet exposures), by type of borrower (e.g. banks, sovereigns and corporates), by sector or by maturity (short-term and long-term) and type of country risk (e.g. sovereign, transfer, political, etc.).

MONITORING OF COUNTRY EXPOSURES

19. Banks shall have in place a structure to evaluate compliance with country exposure limits and sub-limits. The structure shall also include the monitoring of current credit and capital market conditions in countries concerned. The level of resources devoted to the monitoring process shall be commensurate with the level of exposure and the perceived level of risk.

20. A monitoring program shall, at a minimum, cover the following:

- Banks shall have in place an effective Management Information System to generate management reports which shall be detailed enough to enable appropriate review and identification of exceptions, by the board or by any delegated authority, in a timely manner;
- Exceptions shall be reported, approved and rectified as laid down in the country risk management policy;
- Banks shall perform periodic credit reviews and monitoring of their cross-border exposures to identify unusual developments and, if appropriate, initiate necessary actions to protect their interests. As country conditions deteriorate, banks shall increase the frequency of monitoring;
- Where an international bank maintains an in-country office in a foreign country, a report from the local staff shall be a valuable resource for monitoring country conditions; and
- Banks shall have an appropriate mechanism for gathering, in a timely manner, information about developments in countries to which they have exposures and that may have a bearing on their country risk assessment, e.g. rating agencies.

Stress Testing and Contingency Planning

21. Banks shall put in place a framework to stress-test their country exposures for material variations in underlying assumptions. This involves early identification of potential country risk problems and handling of exposures in troubled countries, including contingency plans for mitigating risk and, if the situation so warrants, exiting the country. The level of resources devoted to this effort shall be commensurate with the significance of foreign exposures in the bank's overall operations or its capital base.

22. Banks shall initiate stress-testing exercises at intervals as appropriate and any consequent impact on their balance sheet and income statement shall be reported to their board or such delegated authority.

23. Stress testing does not necessarily call for the use of sophisticated financial modeling tools but rather for the need for banks to evaluate the potential impact of different scenarios on their country risk exposures.

Internal Controls and Audit

24. Banks shall ensure that their country risk management system includes effective internal control processes. The system of internal controls shall detect non-compliance with policies and limits. It shall ensure that the responsibilities of marketing and lending personnel are properly segregated from the responsibilities of those who analyse country risk and set country exposure limits.

25. Banks' internal audit programs shall provide an opinion on the integrity and accuracy of the information used in monitoring compliance with country risk policies and exposure limits and shall ascertain that established policies, limits and procedures are strictly adhered to. Audit conclusions shall be reported to the audit committee for assessment.

SECTION III: COUNTRY RISK PROVISIONING

26. Cross-border exposures give rise to an additional risk apart from the underlying credit risk of the counterparty. It is therefore necessary that banks put in place a system for reflecting the impact of country risk on their balance sheet.

27. One of the ways of accounting for country risk is by setting aside provision for it. Such provision can be held separately, based on the aggregate exposures of a bank to each country, or incorporated in the provision for credit risk itself. The extent of risk may also be diluted by the application of mitigating instruments.

28. The manner in which banks intend to reflect the impact of their cross-border risks on their balance sheet is left to be determined by the banks themselves. However, the provisioning policy approved by the board shall, *inter alia,* elucidate clearly the intended approach and the rationale thereof. For instance, the provisioning policy may be dictated by the availability of political risk insurance cover. In such cases, the board or such other authority shall be satisfied with the nature and extent of the coverage available as well as the inherent strength of the insurer. The policy shall document all relevant information appropriately.

29. Country risk provisions, if set up separately for meeting expected losses arising out of banks' cross-border exposures, can be included in Tier 2 Capital as part of general provisions under the item "*General Banking Reserves and Portfolio Provisions*[3],which in aggregate shall be within the overall ceiling of 1.25 per cent of total risk-weighted assets.

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[3] Breakdown of this item shall be given as a note to the Financial Statements.

SECTION IV: DISCLOSURE REQUIREMENTS

30. Banks shall, in their annual reports, disclose their country risk management policies and controls and shall provide sufficient qualitative and quantitative data to help market participants understand the nature and extent of their exposures. Disclosures shall be made in accordance with the Bank's *Guideline on Public Disclosure of Information.*