Risk Management Systems in Banks - Country Exposure

DBOD.BP. / 21.04.103/ 2001- 02

23 May 2002

All scheduled commercial banks

Dear Sir,

Risk Management Systems in Banks - Country Exposure

We invite a reference to paragraphs 123 and 124 of the Statement on Monetary and Credit Policy for the year 2002- 03 enclosed to our Governor's letter MPD.No. 214/ 07.01.279/ 2001-02 dated April 29, 2002. It has been indicated therein that with a view to moving further in complying with the Core Principles for Effective Banking Supervision drawn up by the Basle Committee for Banking Supervision, RBI would be shortly issuing draft guidelines on country risk management and provisioning therefor. Accordingly, the draft guidelines on country risk management are furnished in the Annexure, along with a 'Note for Discussion' on the subject, for obtaining the views/ comments of banks. We, therefore, request you to ***furnish your bank's views/ comments*** on the draft guidelines ***by 15 June 2002***. The guidelines would be finalised on the basis of the feedback received and are proposed to be issued for implementation by 31 March 2003.

These draft guidelines, along with the 'Note for Discussion' are also available on our website (www.rbi.org.in) seeking the comments of other market participants.

Yours faithfully,

Sd/-

(B Mahapatra)

General Manager

Country Risk Management - Note for Discussion

Reserve Bank of India
Mumbai

The Basel Committee on Banking Supervision, which is a Committee of banking supervisory authorities of G-10 countries, has been in the forefront of the international attempt in the development of standards and the establishment of a framework for bank supervision towards strengthening financial stability throughout the world. In 1997, in consultation with the supervisory authorities of a few non G-10 countries including India, it drew up the 25 'Core Principles for Effective Banking Supervision' which were in the nature of minimum requirements intended to guide supervisory authorities which were seeking to "strengthen their current supervisory regime".

2. The RBI is committed to the full implementation of the Core Principles. The banking system in India is largely compliant with most of the Core Principles. However, we are still noncompliant in respect of one Principle (Principle No.11) which provides that "banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks".

3. Addressing the issue, the Risk Management Guidelines issued in October 1999 required that banks, in connection with their inter-bank exposures, should use the country ratings of international rating agencies and classify the countries into low risk, moderate risk and high risk and endeavour for developing an internal matrix that reckons the counterparty and country risks. Banks were also advised to set country exposure limits and monitor such exposure on weekly basis before switching over to real time monitoring.

4. The Advisory Group on Banking Supervision (Chairman, Shri M.S. Verma), which submitted its Report in July 2001, undertook a detailed analysis of the level of compliance with the above Core Principle. The Advisory Group recommended that RBI may assist banks in hastening introduction of more scientific and sophisticated risk management systems. The Group also recommended that RBI may consider prescribing

provisioning requirements for country exposures until banks are in a position to assess and provide for such risks on objective and scientific basis.

5. While preparing the draft guidelines on country risk management, it was decided to collect data from both public sector and select private sector banks to assess the likely impact of the possible provisioning, which may be required for different categories under different approaches, on the profitability of banks. This was also required to decide on the extent of provisioning requirement which may be prescribed in the country risk guidelines.

6. An analysis of the data and feedback received from banks on country exposures revealed the following:

- ✍ A few public sector banks had not introduced country risk exposure monitoring systems. Many banks did not have a robust reporting system for country exposures. A few banks had not reckoned all exposures involving country risk.

- ✍ Less than fifty percent of the banks covered had fixed country risk exposure limits. These limits, wherever fixed, were a proportion of capital & reserves, or foreign currency assets, or the total of advances & investments. Some banks had not furnished the rationale/ basis for fixing the country exposure limits.

- ✍ A few banks have adopted country risk classification as put out by Euromoney, or Dun & Bradstreet or ECGC.

7. An analysis of the data submitted by the banks on their country risk exposures as also the likely impact of the provisioning requirements is furnished below:

a) <u>Level of Exposures:</u>

(Rs. crore)

Bank Group	**Gross exposures**			**Net Exposures**		
	Low risk countries	Medium risk countries	High risk countries	Low risk countries	Medium risk countries	High risk countries
Public Sector	45681	3056	3309	39343	2593	1532
New Private Sector	6713	226	118	5748	171	114

b) <u>Provisioning requirement:</u>

With a view to assessing the impact of the provisioning requirements that may be prescribed different scenarios were examined. The provisioning requirement <u>*as a percentage of the net funded exposures*</u> as contemplated is as under:

Low Risk	-	0.25 %
Medium Risk	-	2.5 %

High Risk	- 20.0 %

The resulting additional provisioning burden on the bank groups would be as under.

(Rs. crore)

Bank Group	Provisions required
Public Sector	378
New Private Sector	28

c) Capital Requirement:

It was decided to project any increase in capital that may be required to support the current level of country exposure. Accordingly, as an alternative to prescribing additional provisioning requirement the proposal of prescribing additional risk weights for country risk was considered. It was observed from the position prevailing in various countries that almost all the countries have prescribed additional provisioning and not additional capital.

d) It may be observed from the above that the public sector banks shall have to make an additional provisioning of Rs.378 crore and the new private sector banks have to make an additional provisioning of Rs. 28 crore. These are considered to be achievable by these banks. In this regard the following aspects need a mention here.

- At present, some of the banks have computed their country risk exposures only with reference to their inter-bank exposures, as envisaged under the risk management guidelines issued in October 1999. Hence, the actual provisioning burden may be slightly higher when the banks reckon all relevant country risk exposures.

- The provisioning requirement has been worked out on net funded country exposures. One of the items permitted to be netted from the gross exposure on any country is the banks' dues to the respective countries.

- In a few countries the Regulator has prescribed the rate of provisioning. In a few others the rate of provisioning has been left to the discretion of the banks viz. France, Germany, Netherlands, Switzerland, UK and US. The band of provisioning rates in few countries where they have been prescribed are as under:

Country	**Rate of provisioning**
Belgium	10% to 60%
Canada	minimum 35%
Italy	15% to 60%
Japan	Maximum 35%

- It was decided that the provisioning requirements as proposed above may be prescribed at the initial stage on the net exposures. ***The rate of provisioning***

would be reviewed and revised, as and when considered necessary, on the basis of the experience gained.

8. With a view to moving forward in complying with the Core Principles for Effective Banking Supervision, an announcement was made in the Governor's Statement of Monetary and Credit Policy on 29 April 2002 that draft guidelines would be issued on country risk management and provisioning therefor by banks in India which will be finalised in consultation with banks, IBA and other market participants, for implementation by March 2003. Accordingly, the draft guidelines are furnished in the Annexure. These would be open for comments up to 15 June 2002. All interested parties may furnish their feedback to the ***Chief General Manager-in-Charge, Department of Banking Operations & Development, Reserve Bank of India, Central Office*** at the following address:

Postal Address	Centre No.1, World Trade Centre, Cuffe Parade, Colaba, Mumbai – 400 005
Email	cgmincdbod@rbi.org.in
Fax	(022) 2183785 or (022) 2189558

ANNEXURE

Draft guidelines on Country Risk Management by banks in India

Policy & Procedures

1) Banks should formulate appropriate, well documented and clearly defined 'Country Risk Management' (CRM) policies, with the approval of the respective Boards. The CRM policy should address the issues of identifying, measuring, monitoring and controlling country exposure risks. The Policy should specify the responsibility and accountability of the various levels for the country risk management decisions. Banks should also put in place procedures for ensuring that necessary steps are taken in accordance with the CRM policy. The CRM policy should be periodically reviewed by the Board on the basis of the experience gained.

2) Banks should institute appropriate procedures for dealing with country risk problems. They should have in place contingency plans and clear exit strategies, which would be activated at times of crisis. Appropriate systems/ procedures should be laid down with the approval of the Board to handle situations involving significant changes in conditions in any country or involving sharp deterioration in the rating of any country.

3) The CRM policy should stipulate rigorous application of the 'Know Your Customer' (KYC) principle in international activities which should not be compensated by demanding collateral or shortening of maturities. Country risk element should be explicitly recognised while assessing the counter-party risk.

Scope

4) Banks should reckon both funded and non-funded exposures from their domestic as well as foreign branches while identifying, measuring, monitoring and controlling country risks. The scope would be confined to the domestic branches for foreign banks operating in India.

5) Banks should take into account indirect country risk. For example, exposures to a domestic commercial borrower with a large economic dependence on a certain country may be considered as subject to indirect country risk.

6) Exposures should be computed on a net basis i.e., gross exposure ‘minus’ collaterals, guarantees etc. Netting may be permitted for collaterals in/ guarantees issued by countries in a lower risk category. Netting may also be permitted for bank’s dues payable to the respective countries.

Ratings

7) To begin with, banks may adopt the sovereign ratings of international credit rating agencies. However, banks should eventually put in place appropriate systems to move over to internal assessment of country risk within a prescribed period, say by 31 March 2004 (i.e., before new capital accord is implemented).

8) Banks should evolve sound systems for measuring and monitoring country risk. The system should be able to identify the full dimensions of country risk as well as incorporating features that acknowledge the links between credit and market

risk. Banks should use a variety of internal and external sources as a means to measure country risk. Banks should not rely solely on rating agencies or other external sources as their only country risk-monitoring tool. Banks should also incorporate information from the relevant country managers of their foreign branches into their country risk assessments.

9) The frequency of periodic reviews of country risk ratings should be more than once a year and depend on the importance and complexity of the bank's business.

10) IBA may be the central point for preparation/ evaluation of country risk models of banks.

<u>Risk categories</u>

11) Countries can be broadly classified into six risk categories – insignificant, low, moderate, high, very high and off-credit. IBA **would be assigned the responsibility of developing a mechanism for assigning countries to the six risk categories specified above.** Banks may be allowed to adopt a more conservative categorisation of the countries.

<u>Exposure Limits</u>

12) Bank Boards may set country exposure limits in relation to the bank's regulatory capital (Tier I + Tier II) with sub-limits, if considered necessary for products, branches, maturity etc. The basis for setting the limits for the country/ category shall be left to the discretion of the banks' Boards. The country exposure limits set by the Board should be reviewed periodically.

13) Exposure limit for any country should not exceed its regulatory capital, except in the case of insignificant risk category.

14) Banks may also set up regional exposure limits for country groups. They may select the basis for deciding the country groups.

15) RBI may, if it becomes necessary, prescribe a prudential aggregate country exposure limit for the higher risk categories, which would be a multiple of the bank's regulatory capital.

<u>Monitoring of exposures</u>

16) Banks should monitor their country exposures on a weekly basis before switching over to real-time monitoring. However, exposures to high-risk (and above) categories should be monitored on a real-time basis. Banks should switchover to real-time monitoring of country exposures (all categories) by 31st March 2004.

17) The Board should be regularly apprised of the country risk exposures.

18) Management of country risk should incorporate stress testing as one method to monitor actual and potential risks. Stress testing should include an assessment of the impact of alternative outcomes to important underlying assumptions.

19) Country risk management processes employed by banks would require adequate internal controls that include audits or other appropriate oversight mechanisms to

ensure the integrity of the information used by senior officials in overseeing compliance with policies and limits.

Provisioning / Capital requirement

20) Banks shall make provisioning on the funded net country exposures on a graded scale ranging from 0 to 100, according to the risk categories mentioned above. To begin with, banks shall make provisions as per the following schedule:

Risk category	**Provisioning requirement (%)**
Insignificant	0.25
Low	0.25
Moderate	5
High	20
Very high	20
Off-credit	20

21) The provision for country risk shall be in addition to the provisions required to be held according to the asset classification status of the asset. In the case of ‘loss assets’ and ‘doubtful assets’, provision held, including provision held for country risk, shall not exceed 100% of the outstanding.

22) Banks may not make any provision for ‘home country’ exposures.

23) Banks may make a lower level of provisioning (say 25% of the requirement) in respect of short-term exposures (say less than 180 days).

24) The issue of requiring banks to maintain capital to cover country risk would be considered at the time of implementation of the New Capital Accord.

25) Banks shall be allowed to treat the ‘provisions held for country exposures’ on par with the 'provisions held for standard assets' for being reckoned for Tier II capital.

Disclosures

26) Banks should disclose their respective 'country risk management' policies in their Annual Report and also disclose, as a part of the 'Notes on Accounts' to the Balance Sheet as on 31st March each year,
   a. the category-wise country exposures, and
   b. the extent of aggregate provisions held thereagainst.

27) The Statutory Auditors should look into and comment on the country risk exposures and the adequacy of provisions held.

Reporting

Banks should report details of their country-wise exposures to the RBI as a part of their DSB returns along with the details of the provisions held therefor.