Supervisory aspects of country risk

Mr Brian Quinn, an Assistant Director of the Bank concerned with banking supervision, discusses[1] *a range of issues connected with country risk. He starts by examining the statistical difficulties of defining and measuring country risk and goes on to consider ways in which banks should deal with it in their accounting and management systems. From the viewpoint of a banking supervisor, Mr Quinn then addresses the implications of recent debt-servicing difficulties for banks' capital adequacy and their provisioning policies. He concludes that:*

- *Banks are heading in the right direction to strengthen their balance sheets to reflect the risks arising in connection with their holdings of problem sovereign debts; but still more needs to be done.*
- *'It is the job of the banks and the supervisors, working together, and in co-operation with the accounting profession, to rebuild and strengthen the position of the banks so that they are better able to withstand the pressures that a resumption of these problems would bring'.*

I should like to start by defining what I mean by 'country risk', for it is the features which are peculiar to country risk, and which distinguish it from other kinds of risk, which give rise to the difficult issues I shall be discussing later. I take country risk to refer to the situation in which a borrower will be unable or unwilling to meet his obligations to foreign creditors because of conditions affecting the availability of foreign exchange in the country in which he is situated. A wide variety of factors can give rise to such a situation. It may be the result of external economic developments, such as world depression or changes in the oil price. Or it may be the result of developments within a particular country of a political nature or arising from natural disasters such as drought or an earthquake.

'Sovereign risk' should be distinguished. It refers to the particular class of risks which arise when lending to a government or public authority: because of the legal status of the borrower the lender does not have recourse to the usual remedies if he experiences difficulty in recovering his loan. Sovereign risk is most often spoken of synonymously with country risk, since it is generally true that governments are able to generate the money necessary to service their debts in their domestic currency.

The difficulties for a bank in assessing country risk are caused by the features which differentiate country risk from the credit risks incurred in domestic lending. Many of the factors which cause debt servicing difficulties, such as natural disasters or economic depression, similarly affect domestic lending, but where country risk is involved their repercussions reach further: though the borrower may himself be unaffected and remain profitable, he may nevertheless be unable to meet obligations in foreign currencies because of a general shortage. Thus, where country risk is involved, it is generally not enough to consider the borrower's commercial viability as an individual enterprise; account must also be taken of the possibility that developments affecting the country in which he is conducting his business might weaken his ability to meet his obligations.

Measurement and assessment

The starting-point for forming an assessment of country risk will be the economic and financial statistics available on the country concerned. There is, I am sorry to say, a tendency for eyes to glaze and breathing to slow when mention is made of the importance of statistics. It is difficult to interest people in this subject, at least until something goes wrong and the irresistible game of apportioning blame gets under way. That game consists essentially of the exercise of hindsight, whereas the collection and examination of good statistics involves essentially the exercise of foresight. I think I know which exercise involves the more productive expenditure of energy.

In assessing country risk, particular attention has to be paid to the country's external indebtedness as its size and maturity structure will have an important bearing on the country's ability to service any increase in its debt in future. A useful contribution to international debt statistics has recently been made by the IMF which, in collaboration with the BIS, has published in *International Financial Statistics* a new and more comprehensive series of international banking statistics. A similar joint venture

(1) In remarks to a banking conference organised by the Institute of Chartered Accountants in England and Wales, on 14 May.

between the BIS and the OECD has resulted in an interesting new series of statistics aggregating BIS banking statistics with data from the governments of OECD member countries on officially guaranteed and insured export credits.

All such data obviously relate to the past, and the time it takes for them to be published is always a problem. In particular it is important to use one's judgement when forming an assessment of the future based on historic data, but the problems caused by the lag in publication should not be overstated. An intelligent reading of the published statistics[1] should reveal a trend at an early stage in its development.

As well as assessing the relative degree of risk present in lending to different countries, banks need to be able to establish the extent to which they could be affected by developments in a particular country. This is an awkward matter. Because country risk problems can arise in different ways, and because one loan may be vulnerable to developments in more than one country, a system of some sophistication is needed.

There are several features which should play a part in such a system. It should measure the consolidated exposure of a banking group as a whole. This is particularly important for banks which operate through offices in more than one country. If the country exposures which arise in all of these offices are not brought together centrally the senior management will not be in a position to form a properly informed opinion on that exposure.

Going even wider, the measure of country exposure should include not only lending but also exposure arising in other ways not always on the balance sheet, such as through leasing, acceptances and contingent liabilities such as guarantees. There is also an argument, perhaps less strong, that commitments to provide funds in future should also figure in any country exposure measurement system. Perhaps the best way to evaluate commitments is not necessarily in the measure of current exposure but as a figure alongside; but this depends on the nature of the commitment.

It is also important that the system of measurement should allocate exposures to the country where the risk lies, which may not necessarily be the country where the borrower is situated. Transfers of risk arise in several ways. A common example is guaranteed lending, where the obligations of a borrower situated in one country are guaranteed by the resident of a second country. In this case the guarantee should be excluded from the bank's exposure to the first country, but included in its exposure to the second. Transfers of risk can also arise where there is no explicit guarantee. A good example of this is lending to a bank's foreign branches: in most circumstances the risk of this lending could be influenced by developments in the country of the bank's head office, as well as by developments in the country where the branch is located. As we have recently observed, this is a live possibility if the branch mainly serves the purpose of raising funds on behalf of its head office.

There are, I will readily agree, ambiguities in this area. Attention needs to be paid to the unadjusted figures, on the basis of the residence of the borrower, as well as to the adjusted figures. Even in what appears to be the most clear-cut case, where the lending is guaranteed, there can be delays in the guarantee being met, and there is always the risk that the documentation may be subject to dispute.

There are various methods of dealing with the different views of country exposure. One is to use a dual measure: this involves measuring country exposure once purely on the basis of the residence of the borrower, and once after adjusting for risk transfers. Another approach involves allocating some exposures to more than one country: counting them as exposure both in the country where the borrower is resident and in the country to which the risk is transferred. This latter method involves double-counting and the banks having, in aggregate, more country claims than the total of country obligations outstanding. However, this approach may be justified in the case of lending to a bank's foreign branch, particularly if that branch is active in the international interbank market. Here it can reasonably be argued that the existence of the head office in a different country may add to, rather than reduce, the risk. For the branch may still be affected by conditions in the country where it is situated, but will also be vulnerable to a loss of confidence arising from developments in its home country. The same argument may apply to bank's foreign subsidiaries: unless there is an explicit guarantee from the parent there will be no justification for reducing the measure of exposure to the country where they are situated but, for the reasons I have mentioned, it may also be prudent to add them to the measure of exposure to their parent's country.

To some this may sound very untidy. They may believe that there must be a way of producing a single definitive figure for a bank's exposure to a country. If the world itself were a neater and tidier place this might be so. But in measuring country exposure we are trying to measure a bank's vulnerability in the face of a wide range of unforeseeable eventualities. I believe it is unreasonable to look for a single tidy measure when what is being measured is untidy and diverse. Prudent assessment involves dealing with the world as it is and, indeed, can reduce the gap between the actual and the ideal over a period of time.

I am not going to make a recommendation saying that one particular technique of measurement is better than any other. The choice of system will depend on the structure of the individual bank and on the particular nature of its business, but I hope my remarks have

(1) Tables 13–15 of the statistical annex contain regular information in respect of the international banking activity of banks in the BIS reporting area (reproduced by permission of the BIS) and banks in the United Kingdom. Table 15, in particular, gives data on the consolidated external claims of UK registered monetary sector institutions.

outlined the essential features which should be included in any system of country risk measurement and which supervisors will expect to find. What I would like to emphasise, however, is the need to approach the business of measuring country exposure in a constructively imaginative way. There is, as I have said, no 'right' way of doing it. Good statistics will help. A tendency to look to the 'worst case' seems prudent. But, above all, bankers and supervisors will have to use their heads.

Market developments

This is never more important than in a period when the structure of markets is changing, conventions have not yet been established and innovation is proceeding at a rapid pace. I can only mention a few of the changes which have a bearing on country exposure, but I hope they will illustrate my point.

A notable feature of the international capital markets in the past year has been the extent to which the issue of bonds and floating-rate notes (FRNs) has at times exceeded the volume of syndicated lending, with banks as substantial purchasers of this paper. Holdings of marketable instruments pose problems when measuring country exposure. The fact that they may pass quickly through a bank's hands means that if country exposure is measured only on particular dates, the bonds or FRNs which it happens to be holding on those dates may not be representative of its customary holdings. Some banks may also believe that, because of their marketability, bonds and FRNs do not need to be included in the measurement of country exposure, as they can always be sold if there is a problem. This is a mistake, in my view. They are only marketable as long as everything is well; it cannot be true for everyone that they will be able always to sell their holding before the market as a whole is aware of the problem. I believe that if a bank intends to buy bonds and FRNs—for however limited a period it might intend to hold them—they should indeed be measured as part of its country exposure; but more important, it must ensure that they are included within its country limits.

We have heard some talk recently about the development of a secondary market in syndicated loans. Careful consideration needs to be given to the precise means by which one bank transfers part of its exposure to another bank. The transfer may take a variety of forms, ranging from selling a sub-participation in a loan for a limited period to an outright assignment of the loan. These different forms of transfer give rise to different legal rights and liabilities for the two parties and involve documentation of especial complexity. It is important that in any of these transactions there should be no doubt between the parties involved over its legal form and their respective legal rights or liabilities. When measuring country exposure the two banks should include any exposure which they have acquired or any residual or contingent exposure which they have retained.

Controls and limits on country exposure

As well as measuring its exposure to various countries a bank needs to adopt a policy towards controlling these exposures. Such a policy should have as its objectives the achievement of a spread of risks and, within this spread, to ensure that the concentration of exposure in any particular country bears some calculated relationship to the perceived degree of risk involved and the capacity to carry that risk. The outcome of this policy will be a set of limits which should be established in relation to the bank's capital position, and not to the potential business opportunities. Given the importance of this process for a bank with significant international business, the limits should be set at a very senior level within the bank and compliance with the limits should be monitored. This of course means that the bank must have a system for producing a timely and detailed report of its exposures. I need hardly add that the limits set should be reviewed regularly and systematically.

My earlier remarks about the measurement of exposure apply also to the definition of limits, which should cover all the types of transaction which may give rise to country risk. For example, interbank lending to a bank's foreign branches should be included within the limit for the country of the bank's head office, with some cross-reference to the country where the branch is located. Lending to a foreign subsidiary should be included within the limit for the country of incorporation, with a cross-reference to the country of its parent. I recognise that there can be practical problems for a bank with an international network of branches which may simultaneously be making interbank loans giving rise to the same exposure to a given country through different and widely separated branches. Two ways in which these problems can be tackled are by allocating portions of limits to individual branches, or by devising sophisticated monitoring systems able to integrate exposures arising in different parts of the world.

The role of the supervisor

So far I have quite deliberately emphasised the importance of action that can be taken by banks' managements to measure, assess and control their country risks. I use the word deliberately because, as I see it, all this action is in the first and last place the responsibility of management. It is not the supervisor's role in the United Kingdom to take over the task of assessing credit quality or setting exposure limits. The respective roles of the supervisor and the bank's own management were presented in a paper entitled *Management of banks' international lending* prepared by the Basle Supervisors Committee in March 1982, which was distributed to banks in this country and overseas by supervisory authorities.

The supervisor takes one step back from the detail of these processes, as it were, in order to review the systems used by the banks' managements. He will wish to satisfy himself that the banks have in place suitable systems for assessing risk and that they devote adequate resources to this process; that they have a system of weighing these risks and setting limits to control their exposure; and that these limits are appropriate and are observed. In order to form these judgements the supervisor will naturally need to monitor a bank's actual exposures as reported on statistical returns. In our system in the United Kingdom the regular discussion of country exposures with banks at meetings in the Bank of England between their management and the supervisors is a central and essential part of the process of forming a judgement on each bank's assessment and control procedures.

In looking at a bank's country exposures the supervisor is also concerned to judge how those exposures affect his assessment of the overall financial position of the bank. Where the country exposures include a preponderence of lending to high-risk countries or countries experiencing debt servicing difficulties, he will be looking at those exposures in relation to the bank's capital adequacy and its provisions. In the case of foreign banks' branches in London our concern will be with the implications of their country exposures for the adequacy of their liquidity.

Capital adequacy

Let me offer first some general remarks on the matter of capital adequacy. Until recently there has been a tendency for banks' capital to decline in relation to their balance sheet size. Supervisors around the world are in agreement that this tendency should be resisted, and that some strengthening of capital ratios should be achieved. Indeed, banks' results for 1983 in several countries do show a general reversal of this trend, with a number of banks showing stronger capital ratios. British banks participated in this improvement, placing them in a stronger position to withstand any deterioration in their international exposures. Since the end of last year, of course, several British banks active in international lending have come to a decision to provide in full for deferred tax liabilities following changes announced in the Budget. These additional tax provisions, due to be made in 1984, will take the capital ratios of those banks back to something like the levels at the end of 1982. The Bank will expect the banks affected to restore their ratios over a reasonable time. Even so British banks remain comparatively well capitalised by international standards.

The assessment of capital adequacy takes on particular importance at a time when risks present in banks' international business have increased sharply. In this context capital adequacy must be looked at in conjunction with provisioning policy. Capital and provisions are both ways of strengthening a bank's financial position, and they serve complementary purposes. Capital is a general resource which is available to support the whole of the bank's activities; provisions recognise and account for the deterioration that has occurred in the quality of a particular asset or group of assets. General provisions contain elements of both capital and provisions. In its paper *The Measurement of Capital* the Bank stated that general provisions could be included in a bank's capital base where they were 'freely available to absorb future losses'. This means that they must be over and above those that are required for identified bad and doubtful loans. As a matter of principle I would suggest this cannot hold where provision against identified doubtful loans is made by setting aside or 'earmarking' part of the general provision against a particular loan or group of loans; in these circumstances the provision cannot any longer be regarded as freely available. As a matter of practice the appropriate treatment of general provisions for country lending is something that we must discuss with individual institutions.

The calculation of risk asset and gearing ratios is only the first step taken by the Bank of England in assessing the adequacy of a bank's capital. The result of those calculations must be judged in the light of the composition of the bank's loan book and the extent of its provisioning. If a bank had a significant proportion of its loan book out to borrowing countries experiencing debt servicing difficulties and had not provided in a degree we considered to be adequate against those loans, we would expect it to maintain stronger capital ratios than a similar bank with a smaller exposure to problem debtors or with larger provisions. Case by case is the only way this assessment can be made, across-the-board treatment being especially difficult in these circumstances.

Given the arrangements in place in London, capital adequacy is not relevant to the supervision of foreign banks' branches here since we regard them as integral parts of their parent banks and do not require them to have separate capital. The country content and spread of their lending is, however, important for their ability to continue to meet their liabilities in the London market. This was shown recently by the experience of the London branches of some banks which suffered from a loss of market confidence arising from conditions in their home countries. Not only did they face difficulties funding themselves but at the same time a large part of their assets consisted of lending to their home countries which they were, in the circumstances, unable to realise in order to meet their maturing liabilities. This illustrated in the most telling way for our supervision of foreign banks' branches here the close and direct link between country exposure and liquidity. The prudent matching of a branch's assets and liabilities involves not only the consideration of the source and maturity of the branch's funds but also the uses to which they are put. This has led us to look again at the difficult questions of the prudent limits to a branch's concentration of lending to its country of origin and its dependence on the wholesale markets for funding this lending.

Provisions

In considering in more depth the issue of provisions against country risk I have to admit that they raise particular problems. The factors which give rise to debt servicing difficulties, such as poor economic performance, mismanagement or lenders' lack of confidence, are generally capable of being reversed in the medium to long term. Short of outright repudiation, it is rarely possible to state definitively, on grounds of country risk, that a loan will never be repaid. In this respect it differs from the credit risks that may be found in either domestic or international lending where the liquidation or bankruptcy of the borrower puts a clear end to any hopes of recovery. Instead, country risk difficulties have the effect of postponing the prospect of recovery; provisions become necessary if it is postponed to the point where, for all practical purposes, the loan ought to be regarded as irrecoverable, or at least is of such a maturity that the prospect of its full recovery can no longer be regarded with confidence.

The decision on when provisions become necessary and how much to provide is extremely difficult. There are no clear and objective signals to follow. Neither accounting conventions nor supervisory guidelines here or abroad offer much help when considering the relevant questions. Is the borrowing country experiencing temporary or long-term difficulties? Is an IMF adjustment programme agreed and in place? In the light of past experience and current circumstances, is the country likely to have the political will to see the programme through? There is another layer of secondary, but equally important questions. For example, a country's ability to meet its debt service obligations will also depend on its ability to find willing providers of funds; so some assessment will also have to be made of whether potential lenders will have confidence in the country's economic performance.

Various suggestions have been made for ways in which the determination of the required level of provisions might be made more objective, but none of them seems to me wholly satisfactory. Attempts to link provisions to economic criteria, such as debt service ratios, fail to allow for the much more important factors mentioned above such as the confidence of lenders and the political will of the borrowing country. For these reasons, two countries may be in a very similar economic position but the prospects for the servicing of their debts in future may be quite different.

Attempts to look to the market for guidance offer scarcely more encouragement. Suggestions that problem loans should be written down to their current market value presuppose an active secondary market, which does not at the moment exist. Even if such a secondary market did develop I see difficulties in the foreseeable future in using it as a basis for determining the level of provisions. The complications involved in making a market in assets which may not have been originally intended to be marketable would mean that the market would always be likely to be thin, with unrepresentative buyers and sellers. The price determined by the market in these circumstances would not necessarily be a good guide to the value of a loan for a bank which intended to hold it to maturity. There could be times when it would be prudent to set aside a larger provision than that indicated by prices in the secondary market. The price determined by the market for one loan, on particular terms to a particular borrower, would in any case not necessarily be a good guide to the value of a different loan on different terms to a different borrower. I really see no alternative to the use of judgement to determine these questions, difficult though that may be.

It is not surprising, therefore, that a variety of different approaches has been adopted internationally to providing against country risk problems. In this country, specific provisions have been made by some banks for certain countries; other banks have preferred to make additions to their general provisions to cover the increased uncertainty. And a new feature has appeared, the 'earmarked general provision', which is earmarked against loans to a particular country, but is classified as a general provision since it is not made against a specific identifiable loan. In other countries—a notable example is Japan—the basket provisions approach has been adopted. This involves creating provisions against loans to a group of countries and thus falls somewhere between a specific and a general provision.

Taking account of all these different approaches, it is evident that banks in the United Kingdom and other countries have responded to the present heightened risks of their international portfolios by increasing the level of their provisions. I am sure this is a sensible development even if it means that profits are lower as a result. I see very limited comfort and no virtue in reporting profits which purport to conceal, usually unsuccessfully, a deterioration in the quality of a bank's balance sheet.

The supervisors' approach to provisioning follows their approach towards the general subject of country risk. The responsibility for deciding on the level of provisions to be made rests in the first place with the management and directors of the bank concerned. Their decisions must be reviewed and approved by the bank's auditors. As I see it, the supervisor's role is to oversee this process by ensuring that the bank approaches the question responsibly, recognising in full any deterioration which has occurred in the quality of its international assets. As supervisors we would not expect to stipulate particular levels of provisions. If, however, we formed the judgement in the course of discussion with the bank that its response was inadequate we would act to promote some strengthening of that response.

The total of provisions is, in the first instance, seen as more important than whether they are specific, general or earmarked general. Beyond that, it would clearly be desirable for there to be a greater consistency in the approach to provisioning both among banks within a country and between countries. Speaking personally I believe that as a general principle provisions for country risk should be closely identified with the particular exposures to which they relate. This would argue in favour of the provisions being specific, but given the difficulties of assessing what provisions are required, including the fiscal complications, the basket provisions approach has strong attractions: it recognises that there is an increased risk of loss associated with a particular group of assets, even though it cannot be said with certainty which particular borrowers will turn out to have been affected; and it avoids the tactical and political drawbacks of indicating publicly that lending to a particular country borrower is bad or doubtful.

Conclusion

In concluding, I would like to leave you with two central questions facing supervisors.

The first, which is of interest to all supervisors at this point, is 'Are banks heading in the right direction to strengthen their balance sheets?'

This question is of course, at the heart of the supervisory process as it bears on the problem of country risk. There are no absolute standards by which capital adequacy can be judged nor, as I have suggested earlier, provisions against international lending. The only judgements which can be made are relative—relative to other banks, and relative to earlier periods. By this test I think the movement now is definitely in the right direction. I do not mean to imply by this that provisions for country risk were inadequate until now. I have no clear sense of what was right a year ago; but I do now feel the time is right to reflect the risks in the balance sheet. This is a movement shared by banks in many countries and it is important to avoid any sense of complacency, of congratulating ourselves here on what we have done when some others may have in fact done more. I would expect still more needs to be done, but am content not to anticipate this judgement. This leads naturally to a second question 'Is the debt crisis over?' I think it is evident that the initial acute phase is past, and a great deal has been done to reduce the possibility of calamity. Nevertheless, the scale and depth of the problem makes it equally clear that there will be a need for continuing adjustment by debtors and management by creditors, probably for some years to come in some cases, before we are able to return to the normal functioning of the market. As long as this need persists there remains the risk that acute problems may re-emerge.

It is the job of the banks and the supervisors, working together, and in co-operation with the accounting profession, to rebuild and strengthen the position of the banks so that they are better able to withstand the pressures that a resumption of these problems would bring. It is my clear impression that this is perceived by the banking community who, on the whole, need little persuasion on the importance of this matter.