**Risk Management Systems in Banks -**
**Guidelines on Country Risk Management**

**DBOD. BP. BC. 71 / 21.04.103 / 2002- 03**

**February 19, 2003**

All Scheduled Commercial Banks
(excluding RRBs and LABs)

Dear Sir,

**Risk Management Systems in Banks -**
**Guidelines on Country Risk Management**

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 on Banking Supervision, RBI would be issuing guidelines on country risk management and provisioning therefor, in consultation with banks. The guidelines have since been finalised by RBI and are furnished in the Annexure.

2. The guidelines may be placed before the bank's Board at the next meeting and appropriate steps may be taken for their implementation.

3. These guidelines are applicable only in respect of countries where a bank has exposure of two per cent or more of its assets. These guidelines shall be reviewed after one year, taking into account the experience of banks in implementing the guidelines.

4. Please acknowledge receipt.

Yours faithfully,

**( M. R. Srinivasan)**
Chief General Manager-in-Charge

Encls: As above

**ANNEXURE**

## 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. For the present, only in respect of the country, where a bank's net funded exposure is 2 per cent or more of its total assets, the bank is required to formulate the CRM policy for dealing with that country risk problems.

3) The CRM policy should stipulate rigorous application of the 'Know Your Customer' (KYC) principle in international activities which should not be compromised by availability of 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. In the case of foreign banks operating in India, the scope would be confined to their branches in India. An illustrative list of funded and non-funded exposures is furnished below:

| Funded Exposures | Non Funded Exposures |
|---|---|
| • Cash balances<br>• Bank balances<br>• Deposit placements<br>• Investments<br>• Loans and advances<br>• Trade credits/receivables<br>• Overdraft in Vostro Account<br>• Remittances honoured under drawing arrangement<br>• Other monetary assets | • Letters of Credit<br>• Committed lines of credit<br>• Guarantees<br>• Performance bonds, bid bonds, warranties.<br>• Confirmation of LCs issued by foreign banks.<br>• Commitments undertaken against the counter-guarantees of foreign banks. |

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. Indirect exposures may be reckoned at 50 % of the exposure for the purpose of these guidelines. For the present,

only in respect of the country, where a bank's net funded exposure is 2 per cent or more of its total assets, the bank is required to reckon indirect country risk for measuring, monitoring and controlling with that country risk.

6) Exposures should be computed on a net basis i.e., gross exposure 'minus' collaterals, guarantees, insurance etc. Netting may be permitted for cash collaterals, bank guarantees and credit insurance available in/ issued by countries in a lower risk category than the country on which exposure is assumed.

**Ratings**

7) Banks may put in place appropriate systems to move over to internal assessment of country risk. 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. However, the rating accorded by a bank to any country should not be better than the rating of that country by an international rating agency. For the present, only in respect of the country, where a bank's net funded exposure is 2 per cent or more of its total assets, the bank is required to undertake internal assessment of country risk rating.

8) The frequency of periodic reviews of country risk ratings should be at least once a year with a provision to review the rating of specific country, based on any major events in that country, where bank exposure is high, even before the next periodical review of the ratings is due.

9) Till such time, as banks move over to internal rating systems, banks may use the seven category classification followed by Export Credit Guarantee Corporation of India Ltd. (ECGC) for the purpose of classification and making provisions for country risk exposures. ECGC shall provide to banks, on request, quarterly updates of their country classifications and shall also inform all banks in case of any sudden major changes in country classification in the interim period.
For this purpose, banks may contact:

General Manager (Corporate)
Express Towers, 10th floor,
Nariman Point,
Mumbai- 400 021.
Tel No. 022 – 22023490
Fax No. 022 – 22045253

**Exposure limits**

10) 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 and in any case should be at least once a year.

11) Exposure limit for any country should not exceed its regulatory capital, except in the case of insignificant risk category. In respect of foreign banks, the regulatory capital would be the capital (Tier I + Tier II) held in their Indian books.

12) Banks may also set up regional exposure limits for country groups, at the discretion of their Boards. The Board may decide on the basis for grouping of countries and also lay down the guidelines regarding all aspects of such regional exposure limits.

13) RBI may, if it becomes necessary, prescribe a prudential aggregate country exposure limit for the higher risk categories.

**Monitoring of exposures**

14) 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.

15) 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.

16) Boards should review the country risk exposures at quarterly intervals. The review should include progress in establishing internal country rating systems, compliance with the regulatory and the internal limits, results of stress tests and the exit options available to the banks in respect of countries belonging to 'high risk & above' categories. In case, any significant deterioration takes place in respect of any particular country risk or overall exposure, banks should report to the Board such developments in its next meeting, without waiting for the quarterly review by the Board.

17) 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**

18) Banks shall make provisions, with effect from the year ending 31 March 2003, on the net funded country exposures on a graded scale ranging from 0. 25 to 100 per cent, according to the risk categories mentioned below. To begin with, banks shall make provisions as per the following schedule:

| Risk category | ECGC classification | Provisioning requirement (per cent) |
|---|---|---|
| Insignificant | A1 | 0.25 |
| Low | A2 | 0.25 |
| Moderate | B1 | 5 |
| High | B2 | 20 |
| Very high | C1 | 25 |
| Restricted | C2 | 100 |
| Off-credit | D | 100 |

For the present, only in respect of the country, where a bank's net funded exposure is 2 per cent or more of its total assets, the bank is required to make provision for dealing with that country risk exposure.

19) 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, may not exceed 100% of the outstanding.

20) Banks may not make any provision for 'home country' exposures i.e exposure to India. The exposures of foreign branches of Indian banks to the host country should be included. Foreign banks shall compute the country exposures of their Indian branches and shall hold appropriate provisions in their Indian books. However, their exposures to India will be excluded.

21) Banks may make a lower level of provisioning (say 25% of the requirement) in respect of short-term exposures (i.e. exposures with contractual maturity of less than 180 days).

22) 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.

23) 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, subject to the ceiling of 1.25 % of the risk weighted assets.

**Disclosures**

24) Banks should disclose as a part of the 'Notes on Accounts' to the Balance Sheet as on 31st March each year,
   a. the risk category-wise country exposures, and
   b. the extent of aggregate provisions held thereagainst.

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

**Reporting**

26) 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.

Review

27) These guidelines shall be reviewed after one year, taking into account the experience of banks in implementing the guidelines.