Website: www.bb.org.bd

Banking Regulation & Policy Department
Bangladesh Bank
Head Office
Dhaka

BRPD Circular No-07 **Date 13 April 2021 / 30 Choitra 1427**

Managing Directors/ Chief Executives

All Scheduled Banks in Bangladesh

Dear Sir,

Guidelines on Country Risk Management (GCRM) for Banks

With the enhanced international exposure of Bangladesh resulting from gradual economic development, the banking sector is increasingly getting involved in cross border placements, lending and investments that making the banks exposed to country and transfer risk.

As a result, it is imperative that banks have sound risk management policies and practices in place to proactively manage the risks. In this regard, **Guidelines on Country Risk Management (GCRM)** for Banks has been prepared for addressing the risk of both on and off balance sheet exposures to loss of banks cuased by adverse events in a foreign country.

To comply with the international best practices and to build the banking industry more resilient to shocks, all the scheduled banks are hereby directed to take necessary measures and maintain appropriate provisions against the country risk as per the instructions set out in this guidelines.

These guidelines will come into force from January 2022.

Yours Sincerely

(Md. Nazrul Islam)
General Manager
Phone-9530252
E-mail: nazrul.islam122@bb.org.bd

GUIDELINES ON COUNTRY RISK MANAGEMENT (GCRM) FOR BANKS

Bangladesh Bank

Guidelines on Country Risk Management (GCRM) for Banks

Advisor

Abu Farah Md. Nasser, Deputy Governor

Coordinators

Md. Shahidul Islam, Executive Director

Md. Nazrul Islam, General Manager, BRPD

Team Members

Mohammad Shahriar Siddiqui, Deputy General Manger, BRPD

Md Shah Naoaj, CFA, Deputy Director, BRPD

Mir Md Moyazzem Hosen, Deputy Director, BRPD

Foreword

The economy of Bangladesh experienced a persistent GDP growth of 7 percent in the last decade, resulting from a fast-growing manufacturing sector—which includes the second-largest ready-made garment industry in the world—and solid remittance inflows. In line with the economic development of the country, the banking sector also developed significant cross border relationships. Indeed, as country risk may arise due to the risk of exposure to any loss caused by events in a foreign country, and transfer risks may arise because of exchange restrictions imposed by the foreign country, it is imperative to have sound risk management policies and practices in place to safeguard the banks from these risks. In this regard, Bangladesh Bank has prepared this "Guidelines on Country Risk Management (GCRM)" for Banks in line with international best practice under principle 21 of Basel Core Principles (BCPs) for Effective Banking Supervision 2012.

The GCRM sets out the minimum requirements and supervisory perspective of Bangladesh Bank to ensure that banks have adequate policies and processes in place to identify, measure, evaluate, monitor, report and control or mitigate country risk in their placements, lending and investments. The GCRM will make the overall country risk management of banks more appropriate and efficient.

We believe the GCRM shall be a valuable addition to the banks' risk management policies, practices and process. This is an evolving matter, which will regularly be reviewed by Bangladesh Bank to capture the changing dynamics of the economy and business environment as well as cross-border relationship.

Abu Farah Md. Nasser

Deputy Governor
Bangladesh Bank

1. Introduction:

This Guidelines on Country Risk Management (GCRM) for Banks sets out the minimum requirements and supervisory perspective of the Bangladesh Bank (BB) with regard to ensuring that banks have adequate structures, policies and processes in place to identify, measure, evaluate, monitor, report and control or mitigate country risk in their cross-border placements, lending and investments and for maintaining appropriate capital and/or reserves against such risks on a timely basis. This GCRM is issued under section 45 of the Banking Company Act, 1991 following the Principle 21 regarding 'country and transfer risk' of Core Principles for Effective Banking Supervision 2012 of the Bank for International Settlements (BIS).

Country risk refers to the possibility that a foreign obligor may be incapable or unwilling to fulfill his obligations due to country-specific economic, political, social or ecological conditions. These may include the consequences of exchange control, currency devaluation, official government actions or significant socio-political changes in the country where placements, lending and investments made, largely unpredictable events such as natural disasters or external shocks arising from global phenomena such as international treaties and agreements, financial or oil price shock. Indeed, country risk does not include individual counter-party risk but discharge from country-specific issues and is measured and monitored according to where the risk is domiciled rather than where the obligor is domiciled.

2. Definitions

Country Risk: Country Risk is the risk of both on and off balance sheet exposures to loss caused by events in a foreign country[1]. 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 contagion risk, currency risk, indirect country risk, macro-economic risk and transfer risk.

3. Categories of Country Risk

The main categories of Country Risk comprise Sovereign, Contagion Risk, Contagion Risk, Currency Risk, Indirect Country Risk, Macroeconomic Risk, and Transfer Risk.

[1] Reference document: BIS document on Core Principles for Effective Banking Supervision, 2012.

a) **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;

b) **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.

c) **Currency Risk** 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;

d) **Indirect Country Risk** is the risk that the repayment ability of a domestic borrower is adversely affected by any event occurs in a foreign country where the borrower has business interests; and

e) **Macroeconomic Risk** is 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.

f) **Transfer Risk**: 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. [2]

4. General Requirements:

a) Banks should formulate appropriate, well documented and clearly defined 'Country Risk Management' (GCRM) policies, with the approval of the respective Boards. The GCRM 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 GCRM policy. The GCRM policy should be periodically reviewed by the Board on the basis of the experience gained.

[2] Reference document: IMF paper on External Debt Statistics – Guide for compilers and users, 2003.

b) 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 percent or more of its total assets, the bank is required to formulate the GCRM policy for dealing with that country risk problems.

5. Specific Requirements:

a) 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 Bangladesh, the scope would be confined to their branches in Bangladesh.

b) 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 percent or more of its total assets, the bank is required to reckon indirect country risk for measuring, monitoring and controlling with that country risk.

c) 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.

d) 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 2percent or more of its total assets, the bank is required to undertake internal assessment of country risk rating.

e) 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.

6. Exposure limits

a) Bank Boards may set country exposure limits in relation to the bank's regulatory capital (Tier 1) 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.

b) 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) held in their Bangladesh's books.

c) 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.

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

7. Monitoring of exposures

a) Banks should have a system in place to monitor current conditions in each of the countries where it is significantly exposed. The level of resources devoted to monitoring conditions within a country should be proportionate to the level of exposure and the perceived level of risk. If any bank maintains an in-country office, reports from the local staff are an obviously valuable resource for monitoring country conditions.

b) Boards should review the country risk exposures at an annual basis. 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.

c) 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.

8. Risk Rating

a) Country risk ratings summarize the conclusions of the country risk analysis process. The ratings are an important component of country risk management because they provide a framework for establishing country exposure limits that reflect the banks's tolerance for risk.

b) 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.

c) 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. As a minimum, Bank should analyze the Macroeconomic, Social, Political and Legal Factors while analyzing country risk (see annex 1). However, the rating assigned by a bank to any country should not be better than the rating of that country by an international rating agency.

d) Bank should classify the country under following five categories:

i. Insignificant
ii. Low
iii. Marginal
iv. Moderate
v. High

e) The mapping of the risk categories with the sovereign rating[3] of S&P, Fitch and Moody are given below:

Risk Categories	Equivalent Rating of S&P and Fitch	Equivalent Rating of Moody
Insignificant	AAA to AA	Aaa to Aa
Low	A	A
Marginal	BBB	Baa
Moderate	BB to B	Ba to B
High	Below B	Below B

f) For the present, only in respect of the country, where a bank's net funded exposure is 2 percent or more of its total assets, the bank is required to undertake internal assessment of country risk rating.

9. Provisioning / Capital requirement

a) Banks shall make general provisions, with effect from the first quarter of 2022, on the net funded country exposures on a graded scale ranging from 0. 25 to 20 percent. To begin with, banks shall make provisions as per the following schedule:

Risk category	Provisioning requirement
Insignificant	0%
Low	0.25%
Marginal	1%
Moderate	5%
High	20%

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

[3] For the countries for which sovereign rating is conducted by credit rating companies other than S&P, Fitch and Moody, Bank should develop its own policy to map with the risk categories mentioned in point 8(e).

with that country risk exposure. However, exposure of foreign banks at their home country may be excluded in this regard.

b) 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 'bad loans', provision held, including provision held for country risk, may not exceed 100% of the outstanding.

10. Stress Testing

a) Banks should periodically stress-test their foreign exposures and report the results to the board of directors and senior management. As used here, stress testing does not necessarily refer to the use of sophisticated financial modeling tools, but rather to the need for all institutions to evaluate in some way the potential impact of different scenarios on their country risk profiles.

11. Disclosures, Reporting and Monitoring

a) Banks shall disclose as a part of the 'Notes on Accounts' to the Balance Sheet as on 31st March each year,

   i. the risk category-wise country exposures, and
   ii. the extent of aggregate provisions held against the country risk.

b) Banks shall routinely submit the assessment of Country Risk under ICAAP reporting.

c) Bangladesh Bank will routinely determine under onsite inspection and Supervisory Review and Evaluation Process (SREP) that bank's policies and processed give due regard to the identification, measurement, evaluation, monitoring, reporting and control or mitigation of country risk risk. BB will also determine that the processes are consistent with the risk profile, systemic importance and risk appetite of the bank, taking into account market and macroeconomic condition, and provide a comprehensive bank-wide view of country risk exposures. BB will also evaluate whether exposures (including, where relevant, intra-group exposures) are identified, monitored and managed on a regional and an individual country basis (in addition to the end borrower/ end-counterparty basis).

Annex 1: Factors Affecting Country Risk

1. Macroeconomic Factors

The first of these factors is the size and structure of the country's external debt in relation to its economy. More specifically:

- The current level of short-term debt and the potential effect that a liquidity crisis would have on the ability of otherwise creditworthy borrowers in the country to continue servicing their obligations.
- To the extent the external debt is owed by the public sector, the ability of the government to generate sufficient revenues, from taxes and other sources, to service its obligations.

The condition and vulnerability of the country's current account is also an important consideration, including: The level of international reserves, including forward market positions of the country's monetary authority (especially when the exchange rate is fixed).

- The level of import coverage provided by the country's international reserves.
- The importance of commodity exports as a source of revenue, the existence of any price stabilization mechanisms, and the country's vulnerability to a downturn in either its export markets or the price of an exported commodity.
- The potential for sharp movements in exchange rates and the effect on the relative price of the country's imports and exports.

The role of foreign sources of capital in meeting the country's financing needs is another important consideration in the analysis of country risk, including:

- The country's access to international financial markets and the potential effects of a loss of market liquidity.
- The country's relationships with private sector creditors, including the existence of loan commitments and the attitude among bankers toward further lending to borrowers in the country.
- The country's current standing with multilateral and official creditors, including the ability of the country to qualify for and sustain an International Monetary Fund or other suitable economic adjustment program.

- The trend in foreign investments and the country's ability to attract foreign investment in the future.
- The opportunities for privatization of government-owned entities.
- The degree to which the economy of the country may be adversely affected through the contagion of problems in other countries.

Past experience has highlighted the importance of a number of other important macroeconomic considerations, including:

- The degree to which the economy of the country may be adversely affected through the contagion of problems in other countries.
- The size and condition of the country's banking system, including the adequacy of the country's system for bank supervision and any potential burden of contingent liabilities that a weak banking system might place on the government.
- The extent to which state-directed lending or other government intervention may have adversely affected the soundness of the country's banking system, or the structure and competitiveness of the favored industries or companies.
- For both in-country and cross-border exposures, the degree to which macroeconomic conditions and trends may have adversely affected the credit risk associated with

2. **Social, Political and Legal Factors**

The analysis of country risk should also take into consideration the country's social, political and legal climate, including:

- The willingness and ability of the government to recognize economic or budgetary problems and implement appropriate remedial action.
- The degree to which political or regional factionalism or armed conflicts are adversely affecting government of the country.
- Any trends toward government-imposed price, interest rate, or exchange controls.
- The degree to which the country's legal system can be relied upon to fairly protect the interests of foreign creditors and investors.
- The accounting standards in the country and the reliability and transparency of financial information.