

# Safety and Soundness

Capital  
Adequacy  
(C)

Asset  
Quality  
(A)

**Management  
(M)**

Earnings  
(E)

Liquidity  
(L)

Sensitivity to  
Market Risk  
(S)

Other  
Activities  
(O)

## Country Risk Management

February 2016



Office of the  
Comptroller of the Currency

Washington, DC 20219

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# Introduction

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The Office of the Comptroller of the Currency's (OCC) *Comptroller's Handbook* booklet, "Country Risk Management," is prepared for use by OCC examiners in connection with their examination and supervision of national banks and federal savings associations (collectively, banks). Each bank is different and may present specific issues. Accordingly, examiners should apply the information in this booklet consistent with each bank's individual circumstances. When it is necessary to distinguish between them, national banks and federal savings associations are referred to separately.

This booklet applies to all banks<sup>1</sup> with exposure to country risk. In accordance with the OCC's supervision-by-risk approach, examiners use the examination procedures in this booklet to assess a bank's exposure to country risk and to evaluate the adequacy of the bank's country risk management framework. Examiners may supplement these procedures, as appropriate, with procedures detailed in the other *Comptroller's Handbook* booklets. In banks with substantial international activities, examiners should perform country risk management examinations. In other banks with international activities, examiners should perform procedures in this booklet as appropriate, depending on the volume, complexity, and risk of international operations. In midsize and community banks, examiners typically perform a country risk management review in conjunction with an examination of trade finance and services.

## Overview

Country risk is the risk that economic, social, and political conditions and events in a foreign country will affect the current or projected financial condition or resilience of a bank. Country risk is evident in all international activities and can affect any of the OCC's eight categories of risk.

To manage country risk, a bank should identify, measure, and monitor risks and control its level of exposure to foreign countries. The board of directors and senior management must ensure adequate oversight and maintain an effective system of controls over the bank's international activities commensurate with the activities' volume and complexity.

The OCC supervises a wide variety of internationally active banks engaged in a multitude of activities in many foreign countries. Since the financial crisis of 2008 and the European banking and debt crises, it became apparent that country risk is not limited to emerging markets but may affect developed markets as well.

Some of the largest banks provide a broad array of financial products and services through foreign branches, wholly owned foreign banks and subsidiaries, joint ventures, broker-dealers, representative offices, and affiliates. Their clients often are branches or local

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<sup>1</sup> This booklet focuses on banks rather than branches and agencies of foreign banks; the concepts articulated herein, however, also are relevant to these branches and agencies. For more information, refer to the "Federal Branches and Agencies Supervision" booklet of the *Comptroller's Handbook*.

affiliates of the largest global conglomerates as well as large local firms and, increasingly, small and medium-size enterprises and consumers. Such financial offerings have also expanded to include a full complement of capital market products such as derivatives, traded products, and market-making activities.

In contrast, midsize and community banks are exposed to country risk primarily by serving the needs of their domestic, corporate clients. Some of these banks engage in trade finance and correspondent banking and may have close business ties to certain geographic areas, such as Latin America, Asia, or the Middle East.

Country risk issues are more likely to arise as financial markets and economies are increasingly linked, capital markets become more complicated, and third-party relationships involve foreign service providers. Examiners and bankers need to be alert to possible situations that may disrupt operations or lead to losses.

## Risks Associated With International Activities

From a supervisory perspective, risk is the potential that events will have an adverse effect on a bank's current or projected financial condition<sup>2</sup> and resilience.<sup>3</sup> The OCC has defined eight categories of risk for bank supervision purposes: credit, interest rate, liquidity, price, operational, compliance, strategic, and reputation. These categories are not mutually exclusive. Any product or service may expose a bank to multiple risks. Risks also may be interdependent and may be positively or negatively correlated. Examiners should be aware of this interdependence and assess the effect in a consistent and inclusive manner. Examiners also should be alert to concentrations that can significantly elevate risk. Concentrations can accumulate within and across products, business lines, geographic areas, countries, and legal entities. Refer to the "Bank Supervision Process" booklet of the *Comptroller's Handbook* for an expanded discussion of banking risks and their definitions.

Country risk is a broad measure that captures the risks of conducting business activities in a foreign country. At its foundation, country risk is closely tied to strategic risk. All of the other risks mentioned in this booklet arise from the bank's strategic decision to pursue international activities in general and more specifically in a particular country. As described more fully in this section, country risk can amplify and affect each of the OCC's eight categories of risk.

Countries are vulnerable to three general types of crises—sovereign default, exchange rate, and banking system. Currency devaluations, foreign exchange controls, and other political actions such as nationalization or expropriation of assets can affect both domestic and foreign banks. Currency devaluations increase a bank's exposure to credit, price, and liquidity risks. On occasion, country risk concerns in one country may spread to other countries that exhibit similar characteristics or where risks can be transmitted through trade linkages or the

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<sup>2</sup> Financial condition includes impacts from diminished capital and liquidity. Capital in this context includes potential impacts from losses, reduced earnings, and market value of equity.

<sup>3</sup> Resilience recognizes the bank's ability to withstand periods of stress.

financial markets. A currency crisis in one country that spreads to neighboring countries and trading partners could increase a bank's exposures to price risk through an unexpected increase in market volatility across asset classes. This situation is commonly referred to as contagion risk.

The country risk management examination should assess the riskiness of the bank's international activities and the appropriateness of risk management practices. The assessment of country risk applies to the entire balance sheet, including assets, liabilities, and capital, as well as off-balance-sheet items. Examples include lending in foreign currency, the sources of funds (both foreign and local currency), unrepatriated capital, capital markets activities (e.g., foreign exchange, swaps, and other derivatives), and third-party relationships, such as information technology servicing and other outsourcing arrangements with foreign service providers or with service providers that use foreign subcontractors.<sup>4</sup>

## Credit Risk

In international activities, credit risk is amplified by country-specific macroeconomic and political developments, including movements in exchange rates. A devaluation of the local currency can negatively affect obligors that borrowed in a foreign currency if revenues for repayment are generated in the local currency.

A special form of credit risk in international activities is sovereign risk.<sup>5</sup> Sovereign risk is the sovereign (or government) obligor's likelihood of defaulting on its financial obligations. Default may be indicated by any of the following: (1) failure to pay principal and interest fully and on time; (2) accumulation of arrearages; (3) restructuring or rolling over of debt; or (4) inability of the country to meet its external debt service obligations (actual default).

In general, the government may be unable or unwilling to pay its debt. For example, the government may make a unilateral decision to default on its debt for political reasons, such as Russia not recognizing former Soviet Union debt. Alternatively, the government may be forced to default due to inadequate reserves of foreign currencies or a banking system crisis that leads to an exponential increase in sovereign debt that it is unable to service. In the case of Greece, the primary cause of default was fiscal mismanagement that led to an excessive debt level that precipitated debt and banking crises. A similar scenario played out in Argentina in 2001, which also included a currency crisis. Some factors in the assessment of sovereign risk include the levels of short-term external debt, the amount of international reserves available for intervention in the foreign exchange market, and the role of foreign sources of funds in meeting the country's financing needs.

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<sup>4</sup> Refer to the "Supervision of Technology Service Providers (TSP)" booklet of the *Federal Financial Institutions Examination Council Information Technology (IT) Examination Handbook*; OCC Bulletin 2002-16, "Bank Use of Foreign-Based Third-Party Service Providers: Risk Management Guidance"; and OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance."

<sup>5</sup> Refer to "Macroeconomic Factors" in appendix A for areas of consideration in evaluating sovereign risk.

Before the global financial crisis of 2008, emerging market countries were the focus of sovereign default risk concerns. Since 2008, developed countries (such as Greece in 2012 and 2015), however, have also experienced sovereign defaults due to the restructuring of their debts. Therefore, the country risk analysis process should cover all countries, including developed countries in which a bank operates. The depth of analysis should be commensurate with the volume and complexity of exposure.

## Interest Rate Risk

In international activities, interest rate risk is amplified by country-specific macroeconomic and political developments, including sudden and significant increases in interest rates. The causes of sharp interest rate movements can vary. For example, sudden changes in central bank target interest rates can be motivated by a desire to defend the local currency from speculative attacks or in response to an inflationary shock. Even without changes in the central bank's target rate, investors selling government bonds to avoid the possibility of a sovereign default can cause large increases in securities price volatility. In an unstable economic situation, securities of any maturity, whether in local or foreign currencies, can be affected very quickly.

## Liquidity Risk

In a country context, liquidity can be a significant risk that banks should anticipate and manage, especially if a country is susceptible to a crisis. As noted previously, countries are vulnerable to three general types of crises—sovereign default, exchange rate, and banking system—all of which can result in systemic liquidity issues. In the first instance, a bank may not be able to liquidate assets quickly, and at a reasonable price, if other banks and institutional investors concurrently recognize the deterioration in the economic and financial conditions. Depending on the situation, the local interbank market can become dysfunctional, and, in a worst-case scenario, the central bank can declare a banking holiday that closes the banking system for a short period (usually one day to one week but possibly longer). This situation occurred in Cyprus in 2013 and in Greece in 2015. In addition to a banking holiday, particularly in situations involving a depletion in foreign exchange reserves and possibly an exchange rate crisis, the central bank could prohibit banks, businesses, and consumers from exchanging local currency for foreign currency, resulting in liquidity risk for the bank's operations.

Cross-border risk can amplify the liquidity risks associated with international activities. Cross-border risk exists when any foreign unit of a U.S. bank (e.g., a branch or a subsidiary) has assets or liabilities (on balance sheet or off balance sheet) that are not denominated in the local currency. For example, there is cross-border risk if a foreign branch of a U.S. bank is funded in U.S. dollars through head office accounts. Capital and the ability to repatriate it also represent cross-border risk.

Cross-border risk encompasses convertibility and transfer risks. Convertibility risk exists when the ultimate source of repayment is unable to convert its local currency into the foreign currency of payment due to government restrictions or actions. Similarly, transfer risk is the

possibility that an asset cannot be serviced in the currency of payment because of government action limiting the transferability of foreign currency (e.g., Venezuela's imposition of foreign exchange controls in 2003).

Ring fencing, another form of liquidity risk, occurs when foreign regulators require capital and local deposits to remain in the country. Liquidity and capital "trapped" in the local country is unavailable for transfer from one foreign branch or subsidiary to another or to the parent.

## Price Risk

Country risk can amplify the price risk associated with banks' international activities. For example, sudden shifts in actual or perceived country risks can adversely affect the value of a bank's securities and can have secondary or incidental effects in foreign exchange and, depending on the country, commodities markets. If the situation in a country devolves into a crisis, even the pricing of loans, including syndications, can be affected. Further, government and central bank actions or contagion from another country can amplify price risk in any given country as investors sell securities in anticipation of the risk of the first country affecting the second country. The contagion risk could be transmitted through a financial channel to trading portfolios involving products or derivatives through an increase in interest rates or depreciation of the exchange rate.

## Operational Risk

Operational risk can take on additional dimensions in foreign countries from country-specific activities. For example, a basic operational risk occurs in countries that do not have well-developed infrastructure, in which power outages are common and computer networks can become disabled. This can be compounded when civil strife further affects the basic provision of services, such as telecommunications and transportation of staff to offices. During civil strife, U.S. bank offices may be targets of protests and subject to physical damage. Local banking customs and practices with less-developed risk management controls can amplify operational risk from the potential for higher risk of fraud and corruption. Banks may also have challenges controlling third-party providers of services due to less-rigid local regulatory oversight and less-developed legal frameworks.

## Compliance Risk

In international activities, banks face compliance risk from the need to comply with local laws and directives that, at times, may vary significantly or be in direct conflict with U.S. laws. For example, a U.S. bank may be providing trust services for a foreign government and therefore acting at the direction of that government, but the bank has been barred by U.S. courts from executing those directives. Another example involves privacy issues, in which local restrictions prevent banks from sharing information on customers even if compelled to do so by U.S. courts or regulatory rulings. The laws and regulations that are most at risk from

noncompliance include (1) Bank Secrecy Act/anti-money laundering; (2) information security; (3) suitability of products; and (4) outsourcing to third-party providers.<sup>6</sup>

## Strategic Risk

As previously noted, country risk is closely tied to strategic risk. International activities and country-specific activities should be compatible with the bank's strategic goals and direction. A bank should decide in which countries and regions to invest its capital and to what degree. This requires sound strategic planning, effective execution and implementation, and a continuing investment in the personnel and systems necessary to maintain a sound and profitable international operation.

A bank's management and country risk management staff should have the knowledge and experience to recognize, monitor, and mitigate the risks unique to international activities and identify when changes in the economic, political, or social landscape affect the bank's strategy for that country. For example, strategic risk can increase when banks enter or re-enter a country that has a high level of country risk or is emerging from a recent crisis. In particular, this risk is heightened if the country remains subject to a high level of political or social risk.

## Reputation Risk

Reputation risk is inherent in all international activities but can become more prominent if products and services do not conform to local laws and regulations. Banks also can be exposed to adverse opinion and negative publicity by operating in or doing business with countries noted for government corruption, human rights abuses, or military aggression, particularly if viewed, correctly or not, as providing the financing for corrupt governments. Banks also face reputation risk in dealing with foreign politically exposed persons or if persons or businesses have ties to terrorist organizations.

## Risk Management

Each bank should identify, measure, monitor, and control risk by implementing an effective risk management system appropriate for the size and complexity of its operations. When examiners assess the effectiveness of a bank's risk management system, they consider the bank's policies, processes, personnel, and control systems. Refer to the "Bank Supervision Process" booklet of the *Comptroller's Handbook* for an expanded discussion of risk management.

To effectively control the level of risk associated with international activities, banks should have a risk management framework that addresses the broadly defined concept of country risk. A sound country risk management framework includes

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<sup>6</sup> Staff involved in international activities must receive appropriate training on the local laws and regulations of the countries in which they operate.



- oversight by the board of directors and senior management.
- policies and procedures.
- a country exposure reporting system.
- a country risk analysis process.
- a country risk rating system.
- Interagency Country Exposure Review Committee (ICERC) ratings.
- country exposure limits.
- monitoring country conditions.
- stress testing and integrated scenario planning.
- independent risk management, internal controls, and audit.

Country risk management typically resides within a bank’s overall risk management function. Key aspects that examiners should consider and evaluate include its independence from the lines of business, its appropriate coverage of key risks, an effective limit and escalation structure including risk appetite, and appropriate reporting to senior management and the board. The country risk management framework should encompass and assess the country risk associated with the bank’s various business lines. Complexity of country risk management systems should be commensurate with the risk appetite of the bank.

## Oversight by the Board of Directors and Senior Management

The board of directors and senior management should consider country risk and manage it effectively.<sup>7</sup> The board is responsible for periodically reviewing and approving policies governing the bank’s international activities to assess whether they are appropriate and consistent with the bank’s strategic plans, goals, risk appetite, and capital and management strength. Bank policy should clarify and quantify strategic goals and risk parameters, including those for country risk. The board also should review and approve limits on country exposures and address situations when the bank’s risk limits are exceeded, when contagion risk may surface, or when a material concentration risk exists. Through appropriate reporting processes, the board should evaluate how effectively bank management monitors and controls exposure to country risk, including any capital that is allocated to such exposures. The board and senior management should assess the adequacy of qualified staff and training requirements.

## Policies and Procedures

Bank management should develop and implement sound, well-defined policies and procedures for managing country risk. The policies and procedures at a minimum should do the following:

- Define the following risks associated with international activities: country, sovereign, and cross-border risks.

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<sup>7</sup> Depending on bank size and complexity, the board of directors may delegate board functions to board committees. Refer to *The Director’s Book* in the OCC’s “National Bank Director’s Toolkit.”

- Define limits, e.g., country, cross-border, and risk appetite, as well as thresholds for exceptions reporting and approvals.
- Establish country ratings that differentiate the inherent risks among countries.
- Document model methodologies and independent validation.
- Require a strategy for doing business abroad by country and region. The strategy should cover product and service offerings and types of legal vehicles (e.g., branches, banks, affiliates, and joint ventures) to be pursued.
- Delineate clear lines of responsibility and accountability for country risk management decisions with an appropriate balance among in-country managers, regional executives or management committees, and headquarters risk management executives and committees.
- Require periodic board and senior management reporting of country risk exposures that includes an analytical risk assessment and a record of limit exceptions.

Management should assess whether country risk management policies and procedures are clearly communicated throughout bank risk management and with business executives, including in-country management and staff, and whether sufficient resources are dedicated to provide for effective implementation.

## Country Exposure Reporting System

To effectively manage country risk, the bank should have a credible, timely, and reliable reporting system for capturing the volume, types, and terms of foreign exposures, limits, exceptions tracking, defaults, losses, and recoveries. The system should cover all aspects of the bank's operations, including cross-border and in-country exposures, and business-critical third-party relationships.

The board of directors should receive periodic reports, at least annually, on the level of and changes in foreign exposures. More frequent reporting, such as quarterly or monthly, would be appropriate where there are concentrations,<sup>8</sup> more complex product offerings, or deterioration in country conditions that would threaten the earnings, capital, or reputation of the bank. Examples of key reports include portfolio monitoring reports for country exposures, limit reporting, limit exceptions reports, asset quality within countries, and trading limits.

An accurate and timely reporting system also is necessary to support the regulatory reporting of foreign exposures in the Federal Financial Institutions Examination Council's (FFIEC) quarterly Country Exposure Report.<sup>9</sup> The reporting systems, internal and regulatory, should reconcile.

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<sup>8</sup> In general, concentrations that exceed 25 percent of the bank's tier 1 capital plus the allowance for loan and lease losses are considered significant; in some cases, however, lesser degrees of exposure may also be considered significant, such as 5 percent or 10 percent of capital.

<sup>9</sup> Banks, federal savings associations, bank holding companies, and savings and loan holding companies that meet the criteria must file the Country Exposure Report (Form FFIEC 009) quarterly. For details, refer to the [FFIEC Web site](#).

## Country Risk Analysis Process

The bank's country risk analysis process should identify, measure, and assess the major risks associated with its international activities. These analyses should be reported to management and the board of directors with appropriate frequency. The following factors should be considered in evaluating this process:

- Whether the bank has analyzed and assessed the risks,<sup>10</sup> including country, sovereign, and cross-border risks, for each country in which the bank conducts business and whether it has documented those assessments.
- Whether a formal analysis of country risk is conducted at least annually and whether the bank has an effective system for monitoring interim developments.
- Whether the bank considers early warning analyses to inform significant changes in country risk.
- Whether the analysis considers other relevant factors, such as the impact of formal regional pacts (e.g., the Eurozone) on individual country ratings as well as potential contagion from regional developments, like the Asian economic crisis of 1997.
- Whether the analysis includes factors other than macroeconomic ones, such as the rule of law or external political developments and their impact on individual countries' risk ratings.
- Whether the analysis and conclusions are documented and communicated in a way that supports sound decisions.

Conclusions about the level of country risk should reflect an evaluation of the effect of prevailing and potential economic, political, and social conditions on counterparties. Appendix A describes these factors in more detail.

## Country Risk Rating System

A country risk rating summarizes the conclusions of the country risk analysis process. Qualitative and quantitative analysis of the pertinent economic, political, and social risks should determine the rating. As some banks' business activities have expanded and become more complex, so have the banks' country risk rating systems. Some systems differentiate between lending in foreign currency (foreign currency rating) and local currency (local currency rating) since transfer and convertibility risks may not be present when local currency lending is funded by local currency liabilities.

The country risk ratings are an important component of country risk management and should reflect the risk of doing business in a particular country. Individual country risk rating definitions should be clear and distinct within the risk rating scale. These ratings should be factored into the country strategy and limit(s) and, therefore, the level of exposure and capital at risk.

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<sup>10</sup> Country risk assessments should include quantitative (e.g., economic and statistical analysis) and qualitative or judgmental factors.

Within the country risk ratings, institutions may differentiate between public and private sector obligor or facility risk ratings.<sup>11</sup> Typically, a country's private sector credits should not be rated more favorably than its public sector credits (i.e., the bank should impose a "sovereign ceiling" on the rating for all exposures in a country). Any private-sector credit rating assigned that is more favorable than the country rating should require written justification and appropriate approvals from senior management.

## ICERC Ratings

The ICERC rating process is a supervisory tool that focuses on whether the quality of a bank's assets has been impaired by a protracted inability of public or private obligors in a foreign country to make payments on their external indebtedness or whether no definite prospects exist for the orderly restoration of debt service.<sup>12</sup> The ICERC assigns ratings only to countries that have defaulted, which "occurs when a country is not complying with its external debt-service obligations or is unable to service the existing loan according to its terms, as evidenced by failure to pay principal and interest fully and on time, arrearages, forced restructuring, or rollovers."<sup>13</sup>

Accordingly, banks should assign a country risk rating (or comparable risk measure, such as a sovereign or foreign currency rating) that is either the equivalent of, or less favorable than, the ICERC rating(s).<sup>14</sup> The ICERC issues letters to those banks with ICERC-rated country exposures, requiring adherence to the ratings. Examiners should test the accuracy of a bank's internal ratings by comparing them to applicable ICERC ratings.

## Country Exposure Limits

As part of the country risk management framework, internationally active banks should adopt country exposure limits, which may be expressed in various forms including notional amounts or as percentages of capital. Because the limit-setting process often involves various departments within the bank (such as business line managers and country risk managers), country risk limits should balance several considerations, including

- the overall business strategy that guides international activities.
- perceived business opportunities in the country.
- the country's risk rating.
- the bank's appetite for risk.

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<sup>11</sup> Refer to the "Rating Credit Risk" booklet of the *Comptroller's Handbook* for a discussion of informal support or implied guarantees provided by a country's central government for a particular borrower or category of credit.

<sup>12</sup> Refer to 12 CFR 28.52, "Allocated Transfer Risk Reserve."

<sup>13</sup> Refer to *Guide to the Interagency Country Exposure Review Committee Process*, November 2008, p. 2.

<sup>14</sup> Refer to *Guide to the Interagency Country Exposure Review Committee Process*, November 2008, p. 7.

- correlations between countries and levels of exposures to other countries within the same region or trading block.

Limits should be reviewed, challenged where appropriate, and adopted by senior risk management or the board of directors and communicated to all relevant departments of the bank. Limits should be reviewed periodically and approved at least annually. When concerns about a particular country arise, however, limits should be reviewed more frequently. Exceptions or breaches of country exposure limits should be reported to an appropriate level of management or to the board so that the exceptions can be addressed.

Internationally active banks should consider supplementing their aggregate exposure limits with more specific controls. Such controls might take the form of sub-limits on the different lines of business in the various countries, limits by type of counterparties, or limits by type or tenor of exposure. Banks should consider limiting exposure to local currencies.

Although individual country exposure limits are customary, banks should assess correlations due to common systemic factors and consider limits on a broader portfolio or regional basis. A troubled country's problems often affect its neighbors, and adverse effects may extend to geographically distant countries with close economic ties, similar debt profiles, or similar economic, capital market, and financial system structures through contagion risk. By monitoring and controlling exposures on a regional or portfolio basis, banks are in a better position to respond if the adverse effects of a country's problems begin to spread.

## Monitoring Country Conditions

Banks should have a system for monitoring risks and current country conditions. The level of resources devoted to monitoring country conditions should be commensurate with the level of exposure and the level of risk. This system should include a determination for when a country or group of countries warrants elevated monitoring. Banks also should monitor regional conditions and trends.

If banks maintain in-country offices, reports from local staff are a resource for monitoring country conditions. Periodic country visits by regional executives and country risk management, however, are important because first-hand observations help assess the likelihood that economic, social, or political events will elevate any or all key elements of country risk.

## Stress Testing and Integrated Scenario Planning

Stress testing is an important risk management practice that contributes to a banking organization's forward-looking assessment of its risks and better equips the organization to address a range of adverse outcomes.<sup>15</sup> Stress testing procedures should be in place that

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<sup>15</sup> Refer to OCC Bulletin 2012-14, "Interagency Stress Testing Guidance" ("Supervisory Guidance on Stress Testing for Banking Organizations With More Than \$10 Billion in Total Consolidated Assets," 77 Fed. Reg. 29458). Also refer to OCC Bulletin 2012-33, "Community Bank Stress Testing: Supervisory Guidance."

contribute to the early identification and reporting of potential country risk problems and situations where the bank faces heightened risk to its business lines and operations from its international activities. This process also should incorporate contingency and risk mitigation action plans for international activities, such as holding more capital, hedging, reducing lines of credit, adjusting pricing, or, if necessary, for exiting a country under extreme situations.

Banks should regularly stress test their foreign exposures using a variety of scenarios and report the results to senior management and the board of directors. In country risk, scenario analysis is an important risk identification process that utilizes extreme but plausible adverse macroeconomic, political, or social events to estimate their potential impact on bank earnings, operations, and capital.<sup>16</sup> Scenarios should target material or strategic<sup>17</sup> countries, regions, business lines, and products.

Banks should develop scenarios based on the range of risk to which they are exposed. Such scenarios should include

- a severe economic downturn.
- a market shock to its trading book, such as a devaluation of the exchange rate.
- country-specific events, such as a debt restructuring, exit of a country from a currency bloc, a banking system crisis, acts of war, and civil strife.

The bank should estimate macroeconomic and financial market variables over the range of the scenario to help determine the timing and magnitude of one or more country rating actions. Since many country risk events take place within the course of a year, the variables in stress test model(s) used to estimate the scenario should be estimated on a quarterly basis, if not more often. To effectively determine the country risk ratings, the bank should have a country risk rating system that has a well-defined risk rating scale with definitions that are clear and distinct.

An integrated stress testing process involves all material business lines with the collaboration of risk management functions in a given country or region in the development and use of scenarios. The stress testing process should complement the bank's other recovery planning efforts, including the bank's business continuity plans for significant offshore operations. Stress testing should be commensurate with the complexity of the foreign franchise, and models developed for stress testing in the country risk framework should be validated according to the bank's model validation procedures and OCC Bulletin 2011-12, "Sound Practices for Model Risk Management."<sup>18</sup>

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<sup>16</sup> Scenario analysis refers to a type of stress testing in which a banking organization applies historical or hypothetical scenarios to assess the impact of various events and circumstances, including extreme ones.

<sup>17</sup> For example, a strategic country is one that the bank has targeted for significant growth or in which the bank has a material presence.

<sup>18</sup> Model validation is the set of processes and activities intended to verify that models are performing as expected, in line with their design objectives and business uses.

## Independent Risk Management, Internal Controls, and Audit

Country risk management typically is part of the overall risk management function. The bank's board of directors and senior management should ensure that the country risk management framework includes effective independent risk management, internal controls, and audit processes. In this regard, management should ensure country risk management's independence from the lines of business, appropriate coverage of key risks, an effective limit and escalation structure consistent with the bank's risk appetite while effectively identifying and limiting concentrations, and appropriate reporting to senior management and the board.

Independent risk management and the system of internal controls and audit should adequately cover all international activities and exposures. They should detect noncompliance with policy, limits, and local laws. Independent risk management also should review international loan portfolios for differences from ICERC risk ratings (see discussion of the ICERC above) and determine if changes to ratings are required to conform to the ICERC ratings.<sup>19</sup>

Audit staff should comment on the comprehensiveness, relevance, integrity, and accuracy of the information used by the board and senior management to monitor compliance with country risk policies and exposure limits. The staff should perform audits of country risk management and reporting with adequate scope and frequency, and should have appropriate qualifications, training, and experience in this specialized area.

For additional guidance and requirements regarding board and management responsibilities for establishing and maintaining an effective internal control system and audit program, refer to the "Internal Control" and "Internal and External Audits" booklets of the *Comptroller's Handbook*.

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<sup>19</sup> Refer to the glossary for details on ICERC risk ratings and transfer risk.

# Examination Procedures

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This booklet contains expanded procedures for examining specialized activities or specific products or services that warrant extra attention beyond the core assessment contained in the “Community Bank Supervision,” “Large Bank Supervision,” and “Federal Branches and Agencies Supervision” booklets of the *Comptroller’s Handbook*. Examiners determine which expanded procedures to use, if any, during examination planning or after drawing preliminary conclusions during the core assessment.

These procedures apply to all banks with exposure to country risk. In accordance with the OCC’s supervision-by-risk approach, examiners generally use the examination procedures in this booklet to evaluate country risk management. Examiners may supplement these procedures, as appropriate, with procedures detailed in the other *Comptroller’s Handbook* booklets. In banks with substantial international activities, examiners should perform country risk management examinations. In other banks with international activities, examiners should perform procedures in this booklet as appropriate depending on the volume, complexity, and risk of international operations. In midsize and community banks, examiners normally prefer to perform a country risk review in conjunction with a trade finance and services review.

## Scope

These procedures are designed to help examiners tailor the examination to each bank and determine the scope of the country risk management examination. This determination should consider work performed by internal and external auditors and other independent risk control functions and by other examiners on related areas. Examiners need to perform only those steps that are relevant to the scope of the examination as determined by the following objective. Seldom will every step of the expanded procedures be necessary.

**Objective:** To determine the scope of the examination of country risk management and identify examination objectives and activities necessary to meet the needs of the supervisory strategy for the bank.

1. Review the following sources of background information and note any previously identified problems related to country risk management that require follow-up:
  - Supervisory strategy
  - Examiner-in-charge’s (EIC) scope memorandum
  - OCC’s information system
  - Previous reports of examination, supervisory letters, and work papers
  - Correspondence
  - Internal and external audit reports, management responses, follow-up reports, and, if necessary, work papers
  - Internal credit review reports
  - Internal reports on country exposure and foreign operations, including critical third-party relationships



- Bank management’s responses to previous reports of examination, supervisory letters, audit reports, and credit review reports
  - Reports by foreign regulators
  - Form FFIEC 009 (Country Exposure Report) filings for several recent quarters
  - Most current ICERC ratings
2. Obtain from the OCC’s Economics Department any information that may be relevant to the bank’s international activities, such as the Organization for Economic Cooperation and Development country classifications.
  3. Obtain and review the following documents to determine the amount of oversight provided for the bank’s international activities:
    - A list of board and senior management committees that supervise the bank’s international activities, including a list of members and meeting schedules. Also review copies of the minutes documenting the meetings of these groups since the last examination.
    - Policy and procedures manuals; reports related to the bank’s international activities and country exposures that have been furnished to the board of directors, board or management risk committee, country risk management committee, or any similar committee; and any other tools used by management to supervise the bank’s international activities, including
      - written policy and procedure manuals.
      - strategic and business plans for international activities and significant individual countries.
      - list of products, services, and business initiatives.
      - list of offshore operations and critical foreign third-party relationships.
      - due diligence or risk assessments for new products or services.
      - country limit and exposure reports, including exposure of sovereigns to legal lending limits (12 CFR 32.5(f)).
      - country risk analysis and rating reports.
      - concentration reports.
      - exception reports.
      - reports on the results of any financial modeling tools, stress tests, and scenario analyses that may have been applied to the bank’s international portfolio.
      - country watch lists, and early warning metrics and analyses.
      - risk assessment reports.
      - expected and unexpected loss analyses.
    - Background information on the country risk management department, including
      - organization chart.
      - management résumés and staffing analysis.
  4. Through discussions with management (including the head of country risk, head of risk, head of line of business, and head of operations, as appropriate) and a review of

requested information, identify any areas of significant change or possible concern in the bank's international activities, including

- any significant changes in policies, procedures, or personnel.
  - any significant changes in the profitability or overall risk profile, such as the level and trend in delinquencies and losses.
  - any changes in models, including updates, back-testing results, and model validation and review.
  - any significant changes in country ratings and watch lists.
  - how country risk management is integrated into enterprise risk management.
  - any significant changes in the level of concentrations or the number of exceptions granted to established limits.
  - how exposures are defined (gross or net) and how limits are set (percentage of capital).
  - any limit excesses and mitigation strategies.
  - the use of foreign-based technology service providers and other third-party providers.<sup>20</sup>
  - for capital markets activities, whether exposure amounts consider the impact of peak potential future exposures on counterparty transactions and wrong-way risks.<sup>21</sup>
  - any internal or external factors that could affect the level of risk associated with the bank's international activities, including
    - changes in country exposure limits.
    - new products.
    - rapid growth in products, countries, or regions.
    - material changes in offshoring or the use of foreign third-party relationships.
    - economic conditions and operating environment in the countries and regions in which the bank has exposures, including any regulatory, political, or other constraints.
5. Based on an analysis of information obtained in the previous steps as well as input from the EIC, determine the scope and objectives of the country risk management examination.
  6. For examination staffing, consider external sources from the Economics Department, a country risk team lead from another institution (to provide a cross-view into another institution's practices), the London office, and International Banking Supervision–Headquarters.
  7. Select from the following examination procedures the necessary steps to meet examination objectives and the supervisory strategy.

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<sup>20</sup> Refer to OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance," for an expanded discussion of foreign-based third-party providers.

<sup>21</sup> Refer to the glossary for the definition of wrong-way risk and the "Risk Management of Financial Derivatives" booklet of the *Comptroller's Handbook*.

## Quantity of Risk

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**Conclusion: The quantity of risk is  
(low, moderate, or high).**

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**Objective:** To determine the quantity of country risk associated with the bank's international activities.

1. Analyze the volume and distribution of the bank's international activities, including commitments and other off-balance-sheet exposures, noting any changes since the previous examination. Determine the implications for risk of the following:
  - Loans and other credit exposures, as well as international capital market transactions (e.g., foreign exchange, swaps, and other derivatives).
  - Significant country or regional concentrations of exposure.
  - Serious economic or other problems in countries in which the bank has significant exposures.
  - Significant growth in exposures to local residents.
  - Significant growth in exposures to a particular economic sector within a country (e.g., banking, commodity producers, manufacturing, or the public sector).
  - Significant exposures to or growth in a geographic region, economic unions, or currency blocs.
  - Significant growth in any existing international products or activities.
  - Any new or planned international products or activities.
  - Share of international consolidated revenues and income.
  - Results of internal and regulatory stress testing applied to the bank's international portfolio, including stress tests conducted by the bank's holding company.
2. Analyze the type, mix, and sources of in-country and cross-border funding, noting any changes since the previous examination. Consider reliance on short-term, high-cost, or borrowed funds, sources of contingency funds, and expectations for, and management of, large inflows or outflows of funds. If there are gaps in examination coverage of activities such as hedging and market-making, raise this as a supervisory strategy issue to be addressed with the EIC and appropriate team leads.
3. Evaluate the risk of exposures to sovereigns and determine compliance with the legal lending limit (12 CFR 32.5(f)) by comparing each sovereign exposure to the legal limit.
4. Ensure that all loans in a rated country have the appropriate ICERC rating and allocated transfer risk reserves (ATRR).
5. If the bank has acquired any significant new foreign affiliates since the previous examination, analyze the effect of these acquisitions on the risk profile of the bank. Consider

- the nature and volume of the affiliate's activities.
  - the affiliate's potential to adversely affect the bank's reputation.
6. If the bank has significant operational processes offshore or has contracted with critical foreign-based third-party service providers, analyze the oversight of these operations from a country risk perspective. Consider
- the nature, volume, and criticality of the operation.
  - the arrangement's potential to adversely affect the bank's reputation.
7. Review the business or strategic plan for the bank's international activities. Consider
- growth goals and exposure limits for individual countries and for regions.
  - new and planned products and business lines.
  - whether the country strategy is linked to and properly aligned with country risk.
8. Review and consider the quantity of risk identified in internally prepared risk assessments of the bank's international activities.

## Quality of Risk Management

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Conclusion: The quality of risk management is  
(strong, satisfactory, insufficient, or weak).

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The conclusion on risk management considers all risks associated with country risk management.

### Policies

Policies are statements of actions adopted by a bank to pursue certain objectives. Policies guide decisions, often set standards (on risk limits, for example), and should be consistent with the bank's underlying mission, risk appetite, and core values. Policies should be reviewed periodically for effectiveness and approved by the board of directors or designated board committee.

**Objective:** To determine whether the bank has established and effectively communicated the policies and standards necessary to manage country risk.

1. Evaluate relevant policies and procedures to determine whether they provide appropriate guidance for management of country risk associated with the bank's international activities. Consider the adequacy of
  - country risk definitions and measures, including definitions for sovereign and cross-border related risks.
  - limits, including as a percentage of capital, risk measurements, and country ratings.
  - periodic board and senior management reports of country risk exposures, including country risk analysis and limit exceptions. Examples of key reports would include portfolio monitoring, limits and limit exceptions, asset quality, and trading exposures.
  - contingency planning (e.g., continuity of international business, resolution planning, de-risking, or exit strategy).
  - stress testing framework, including scenario analysis.
  - strategy for doing business abroad—in total, by region, and by country. It should cover product and service offerings, types of legal vehicles (e.g., branches, banks, affiliates, and joint ventures), levels of risk, and returns on allocated capital.
  - whether clear lines of responsibility and accountability exist for country risk management decisions with an appropriate balance among in-country managers, regional executives or management committees, and headquarters risk management executives and committees.
  - whether management has clearly communicated country risk management policies and procedures.
2. Review the governances used to establish country exposure limits and reasonableness of the limits. Consider

- the method for establishing limits (for example, whether capital or another notional standard is used to define the exposure limit).
- whether limits are reviewed periodically and approved by the board of directors or senior management as appropriate at least annually.
- the roles and responsibilities of all relevant senior executives (e.g., line of business, independent risk management, strategy).
- whether limits are properly rationalized, fully documented, and challenged by senior management or the board of directors as appropriate.
- whether the country risk management function is sufficiently independent from the line of business in terms of measuring and limiting country risk exposure.
- the requirements for reviewing and approving country exposure limits and exceptions, and whether limit breaches are approved ex-ante or ex-post.
- whether the exposure limits are aligned with the bank's risk appetite, country strategies, and country risk ratings.
- whether the exposure limits include the use of sub-limits for different types and terms of exposure within a country, as well as the use of regional sub-limits to mitigate contagion risk across countries and regions.

3. Determine compliance with country risk policies and standards.

## Processes

Processes are the procedures, programs, and practices that impose order on a bank's pursuit of its objectives. Processes define how activities are carried out and help manage risk. Effective processes are consistent with the underlying policies and are governed by appropriate checks and balances (such as internal controls).

**Objective:** To determine whether the bank has systems to provide accurate and timely assessments of the country risk associated with its international activities.

1. Commensurate with the size and sophistication of the bank's international activities, evaluate the adequacy of the bank's country risk analysis process. Consider
  - whether the bank assesses the level of risk, including sovereign and cross-border (including transfer and convertibility risk), associated with each country in which the bank is conducting or planning to conduct business.
  - whether a formal analysis of country risk is conducted at least annually and whether the bank has an effective system for monitoring developments in the interim (such as early warning systems).
  - whether the analysis takes into account all material aspects of country risk as well as any special risks associated with the bank's strategy.
  - the effectiveness of the bank's process to ensure legal and regulatory compliance with (1) Bank Secrecy Act/anti-money laundering regulations; (2) regulations regarding information security requirement and procedures; (3) regulations relating to

determining the suitability of products for a given client; and (4) local laws and the Foreign Corrupt Practices Act.

- the effectiveness of the models used in quantifying risk from country activities and whether they are properly validated.
  - whether the bank has implemented a reasonable stress testing system including scenario analyses.
  - whether the bank has a process to develop contingency and action plans to address adverse situations and trends.
  - whether the level of resources devoted to monitoring country conditions is commensurate with the level of exposure and the level of risk.
  - whether the system includes a determination for when a country or group of countries warrants elevated monitoring.
  - how the bank monitors regional conditions and trends. This might include internal reports from countries as well as periodic visits to regions and major countries by country risk management executives.
  - whether the level of country risk rating incorporates an evaluation of the effect of prevailing and potential economic, political, and social conditions. Refer to appendix A for details.
  - whether all countries are analyzed and assessed.
2. Evaluate the adequacy of the documentation supporting the bank's country risk management decisions. Consider
- whether the bank's country risk files include (at a minimum) a current analysis of country risk, the bank-assigned rating of country risk, authorized types of activities, and approved exposure limits.
3. Evaluate the bank's system for assigning country risk ratings. Consider
- whether the ratings are factored into the country strategy and limits, level of exposure, and capital at risk.
  - whether the country risk rating system adequately surfaces issues pertaining to sovereign risk and cross-border risks.
  - whether the country risk rating (including applicable ICERC rating) serves as the maximum rating for country exposures. Any credit rating assigned that is more favorable than the country rating should require written justification and appropriate approvals.
  - the rating category definitions used and whether they are sufficiently clear and granular.
  - independence (i.e., the staff members involved in the rating process do not have conflicting interests such as line of business responsibilities).
  - what triggers rating changes and whether the changes are timely and appropriate.
  - whether the models have been independently validated (comply with OCC Bulletin 2011-12, "Sound Practices for Model Risk Management").
  - the rating review and approval process.

- the reasonableness of the assigned ratings in light of information available from other sources.
- whether the bank has assessed the risks for each country in which the bank conducts or is considering conducting business and whether it has documented those assessments.
- whether a formal analysis of country risk is conducted at least annually and whether the bank has an effective system for monitoring interim developments.
- whether the analysis takes into account all material aspects of country risk—including sovereign and cross-border (transfer, convertibility)—as well as any special risks associated with specific groups of counterparties.
- whether the analysis considers legal issues in which contracts or agreements involve foreign legal frameworks and dispute resolution.
- whether the analysis considers other relevant factors, such as the impact of formal regional pacts (e.g., the Eurozone) on individual country ratings, as well as potential contagion from regional developments (such as the Asian economic crisis of 1997).
- whether the analysis adequately accounts for external political developments and their impact on individual countries' risk ratings.
- how the country risk rating affects individual obligor and facility ratings within that country (e.g., whether obligor and facility risk ratings are appropriately capped, given the country or sovereign risk rating).
- whether the analysis and conclusions are documented and communicated in a way that enables sound decision-making.

4. Determine the adequacy of stress testing of the bank's international activities.<sup>22</sup> Consider

- whether the bank periodically stress tests its foreign exposures using a variety of scenarios and reports the results to its senior management and the board of directors.
- whether stress testing is commensurate with the complexity of the bank and its level of international activities, including the countries in which it operates or to which it is directly or indirectly exposed.
- whether scenarios target material or strategic<sup>23</sup> countries, regions, business lines, and products.
- whether scenarios are based on the range of risks to which the bank is exposed. For example,
  - a standard scenario for a country could be a severe economic downturn.
  - a market shock to its trading book.
  - scenarios that include country-specific events, such as a debt restructuring or exit of a country from a currency bloc; acts of war or civil strife; or imposition of currency controls or transferability restrictions.

<sup>22</sup> Refer to OCC Bulletin 2012-14, "Interagency Stress Testing Guidance" ("Supervisory Guidance on Stress Testing for Banking Organizations With More Than \$10 Billion in Total Consolidated Assets," 77 Fed. Reg. 29458). Also refer to OCC Bulletin 2012-33, "Community Bank Stress Testing: Supervisory Guidance."

<sup>23</sup> For example, a strategic country could be a country that the bank has targeted for rapid growth that is not yet material to its operations.



- whether stress tests reveal countries and situations in which the bank faces heightened risk. The stress tests' results should include how changes to the bank's country rating(s) would be implemented over the course of the scenario.
  - whether the rating changes factor in an expert assessment of macroeconomic and financial market variables estimated at an appropriate frequency, such as monthly or quarterly, over the course of the scenario.
  - whether the integrated stress testing process involves all material business lines with the collaboration of risk management functions in a given country or region in the development and use of scenarios; and whether this process also incorporates contingency and action plans, such as holding more capital, risk mitigation, reducing lines of credit, or adjusting pricing or, if necessary, exiting a country.
5. Evaluate the effectiveness of the internal controls for managing country risk. Complete the Internal Control Questionnaire (ICQ), if necessary, to make this determination. Refer to the "Internal Control" booklet of the *Comptroller's Handbook* for additional guidance. Consider whether internal controls
- check for and detect significant increases in the country risk profile.
  - check for compliance with ICERC risk ratings.<sup>24</sup>
  - test for compliance with policy, limits, the Foreign Corrupt Practices Act, and local laws.

## Personnel

Personnel are the bank staff and managers who execute or oversee processes. Personnel should be qualified and competent, have clearly defined responsibilities, and be held accountable for their actions. They should understand the bank's mission, risk appetite, core values, policies, and processes. Banks should design compensation programs to attract and retain personnel, align with strategy, and appropriately balance risk-taking and reward.

**Objective:** To determine management's ability to manage the country risk associated with the bank's international activities in a safe and sound manner.

1. Through discussions with management, ascertain its experience and training, and its knowledge of current policies for managing the country risk associated with the bank's international activities.
2. Review the bank's organization chart in conjunction with management résumés to assess the overall structure and experience of personnel responsible for managing the bank's international activities. If no chart is available, discuss structure and experience with department management.

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<sup>24</sup> Refer to the glossary for details on ICERC risk ratings and transfer risk.

3. Evaluate whether reporting lines and independence of country risk management are clearly established, encourage open communication, and limit the chances of conflicts of interest.
4. Evaluate the level of staff turnover and its effect on country risk management.
5. Evaluate the adequacy of staffing (roles and responsibilities, training, number, and experience of staff) and effectiveness of systems to determine and maintain adequacy, including the use of staffing models. Determine whether staffing levels are appropriate for the volume and complexity of the work.
6. Assess performance management and compensation programs. Consider whether these programs measure and reward performance that aligns with the bank's strategic objectives and risk appetite.

If the bank offers incentive compensation programs, determine whether they are consistent with OCC Bulletin 2010-24, "Interagency Guidance on Sound Incentive Compensation Policies," including compliance with its three key principles: (1) Provide employees with incentives that appropriately balance risk and reward; (2) Be compatible with effective controls and risk management; and (3) Be supported by strong corporate governance, including active and effective oversight by the bank's board of directors.

7. If the bank has third-party relationships that involve critical activities, determine whether oversight is consistent with OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance."

## Control Systems

Control systems are the functions (such as internal and external audits, and quality assurance) and information systems that bank managers use to measure performance, make decisions about risk, and assess the effectiveness of processes and personnel. Control functions should have clear reporting lines, sufficient resources, and appropriate access and authority. Management information systems (MIS) should provide timely, accurate, and relevant feedback.

**Objective:** To determine whether the bank has systems in place to provide accurate and timely assessments of country risk.

1. Determine whether data systems accurately and completely capture all activities subject to country risk. Consider
  - whether transactions properly reflect cross-border risk.

- whether claims<sup>25</sup> are captured properly (e.g., with country-specific netting regulations accurately reflected in trading systems).
  - whether offshore operations and third-party relationship exposures are captured.
  - the audit testing of the accuracy of the country exposure reports received by management and the quarterly Form FFIEC 009 (Country Exposure Report) to determine whether the information is accurate and complete.
2. Evaluate the adequacy of the MIS reporting for the bank's international activities. All evaluations of MIS should assess timeliness, quality, accuracy, level of detail, clarity of report format, and the amount and suitability of information provided to management and the board of directors. Consider
- country risk exposure levels relative to regulatory or economic capital.
  - cross-border exposures, including balance sheet and off balance sheet.
  - commitments, including type, amount, and level of expected usage.
  - exposures relative to legal lending limits (12 USC 84(a) and 12 CFR 32.5(f) for national banks, and 12 USC 1464 (u) and 12 CFR 32.5(f) for federal savings associations).
  - exposures related to offshore operations and critical foreign-based third-party relationships.
  - country exposure trends and analysis.
  - concentrations of assets, liabilities, and off balance sheet.
  - type, mix, and sources of funding.
  - exceptions to and breaches of policy and country risk limits, including source, approval, mitigation, duration, and tracking.
  - distribution of exposures across country risk rating categories.
  - the history of changes in bank country risk ratings.
  - whether the reports can be generated in an accurate, timely, and flexible manner. Can country exposure information be reported a number of ways (for example, by sector, by product, or by in-country obligor) and on short notice?
3. If the bank uses models in the management of its country risk (such as risk rating, early warning, limit setting and economic capital, and stress testing models), assess the following:
- Purpose, use, and conceptual soundness of the models.
  - Reasonableness of the assumptions underlying the scenarios used in the stress tests, including scope and severity.
  - The quality of data used as an input, such as macroeconomic and financial market variables.
  - The comprehensiveness of model output to assess the stress scenario outcome.

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<sup>25</sup> Claims include a wide variety of assets including deposit balances at banks, federal funds sold, loans, securities, holdings of acceptances of banks, customer's liability on acceptances outstanding, trade date receivables, and positive fair value of interest rate, foreign exchange, equity, commodity, and other derivative contracts.

- The use of expert judgment in model development and interpretation of the results.
  - The reasonableness of country rating changes—frequency and magnitude—over the stress test.
  - Frequency of overrides (e.g., changes to model results including ratings or limits) and supporting rationales.
  - How management uses the results of the models.
  - Adequacy of model development, management, and validation in accordance with OCC Bulletin 2011-12, “Sound Practices for Model Risk Management.”
4. Test the accuracy of the country exposure reports received by management and the quarterly Form FFIEC 009 (Country Exposure Report) to determine whether the information is accurate and timely. Coordinate any review of Form FFIEC 009 with the examiner conducting the review of regulatory reports.
  5. Determine how compliance with country risk limits is monitored and reported to senior management and the board of directors. Consider the following:
    - The board of directors should periodically receive reports on the level of and changes in foreign exposures and limits, particularly material exposures.
    - More frequent reporting may be appropriate when there are concentrations or deterioration in country conditions that might threaten the earnings, capital, liquidity, or reputation of the bank.
  6. Determine whether the control functions are independent. Consider
    - reporting lines (usually within independent risk management).
    - budget oversight.
    - performance evaluation.
    - compensation plans (staffing adequacy and turnover).
    - access to the board.
  7. Evaluate the effectiveness of the audit function in testing the bank’s framework for managing country risk. Consider the
    - adequacy of the scope and coverage of reviews of the management of country risk including the adequacy and accuracy of MIS and compliance with local laws and the Foreign Corrupt Practices Act.
    - frequency of reviews.
    - qualifications, training, experience, and independence of audit personnel.
    - comprehensiveness and accuracy of findings.
    - adequacy and timeliness of follow-up.
  8. Determine whether the various control functions coordinate their findings.

## Conclusions

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Conclusion: The aggregate level of risk is  
(low, moderate, or high).  
The direction of risk is  
(increasing, stable, or decreasing).

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**Objective:** To determine, document, and communicate overall findings and conclusions regarding the examination of country risk.

1. Determine preliminary examination findings and conclusions and discuss with the EIC, including
  - quantity of country risk.
  - quality and effectiveness of country risk management and board oversight.
  - aggregate level and direction of country risk.
  - violations, matters requiring attention, and other concerns.
  - appropriateness of strategic and business plans for the bank's international activities.
  - adequacy of and adherence to policies and country exposure limits.
  - adequacy of systems for analyzing country risk and assigning risk ratings.
  - adequacy of process for managing country risk, including internal controls, MIS, and audit.
2. Provide assistance in assessing the effect of country risk on the OCC's eight categories of risk. Share information on country risk with other examiners, including the specialty risk teams such as wholesale and retail credit, capital markets, bank information technology, asset management, corporate governance, and compliance, as appropriate.
3. Determine whether capital is adequate for the level of country risk exposure.
4. Discuss examination findings with bank management, including violations, recommendations, and conclusions about risks and risk management practices. If necessary, obtain commitments for corrective action.
5. Compose conclusion comments, highlighting any issues that should be included in the report of examination. If necessary, compose matters requiring attention for the country risk management examination.
6. Update the OCC's information system and any applicable report of examination schedules or tables.
7. Write a memorandum specifically setting out what the OCC should do in the future to effectively supervise country risk management in the bank, including time periods, staffing, and workdays required.

8. Update, organize, and reference work papers in accordance with OCC policy.
9. Ensure any paper or electronic media that contain sensitive bank or customer information are appropriately disposed of or secured.

## Internal Control Questionnaire

An ICQ helps an examiner assess a bank's internal controls for an area. ICQs typically address standard controls that provide day-to-day protection of bank assets and financial records. The examiner decides the extent to which it is necessary to complete or update ICQs during examination planning or after reviewing the findings and conclusions of the core assessment.

1. Has the board of directors, consistent with its duties and responsibilities, adopted written objectives and policies for country risk management? Do these policies and objectives
  - establish country exposure limits for credits, including sub-limits for transfer risk?
  - establish limits for distribution of credits by type and maturity?
  - acknowledge concentrations of credit within countries, and acknowledge the need to employ personnel with appropriate specialized knowledge and experience to supervise those concentrations?
  - address offshore operations and critical foreign-based third-party relationship exposure?
2. Are objectives and policies for international loan portfolio management reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are significant changes in country conditions and levels of exposure brought to the attention of the board of directors or its designated committee promptly?
4. Are country limits revised in response to substantive changes in economic, political, legal, and social conditions within particular countries?
5. Is a formal analysis of country risk prepared, and are country limits reviewed, updated, and approved by the board of directors at least annually?
  - Does the analysis take into account all aspects of the broadly defined concept of country risk, as well as any unique risks associated with specific groups of counterparties that the institution may have targeted in its business strategy?
  - Is the analysis adequately documented, and are conclusions concerning the level of risk communicated in a way that provides decision makers with a reasonable basis for determining the nature and level of the institution's exposures in a country?
  - Are the bank's conclusions concerning a country reasonable in light of information available from other sources, including external research and rating services and the ICERC?
6. Before granting additional advances or commitments, are outstanding advances or commitments checked against appropriate country limits?
7. Is there an internal review system to determine that international assets outstanding and committed are within the bank's foreign exposure limits?

8. Are procedures for approving breaches of country limits clearly defined?
9. Do the country risk executives periodically visit countries where the bank has a major franchise presence in order to glean insight into that country's affairs?
10. Are country risk factors (economic, political, legal, and social) and other factors in a particular country considered in the bank's internal periodic review of its risk assets?
11. Does the bank's system for maintaining adequate and current country analysis information include
  - a review of country conditions on a regular basis? (State frequency and indicate who performs analyses.)
  - a continuing review of current country data obtained from internal and external sources?
  - an analysis of economic, political, social, legal, and other factors affecting country risk?
12. Does the bank have a formal reporting system on country risk?
13. Does the bank's country risk evaluation system accurately recognize exposure from country to country based on legally binding guarantees, collateral, or reallocation by office of responsibility?
14. Are the exposure reporting systems sufficiently flexible to provide accurate and comprehensive information within a short time?
15. Is a regular determination made about each country's transfer risk, including whether transfer risk has increased due to the central bank's restraints and whether the country has exchange controls and hard-currency restrictions?
16. Has the bank implemented the ICERC risk ratings?
17. Has the bank adequately provided the required ATRR in accordance with ICERC requirements?
18. Given the risk profile and complexity of the institution's international activities, are the resources devoted to the analysis of country risk adequate?

## **Conclusion**

19. Based on answers to the foregoing questions, internal control for country risk is considered (strong, satisfactory, insufficient, or weak).



# Appendixes

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## Appendix A: Factors Affecting Country Risk

The debt crises experienced by a number of developed and emerging market countries over the past 25 years have focused attention on several factors that are particularly relevant to the analysis of country risk.

### 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 or devaluation would have on the ability of otherwise creditworthy borrowers in the country to continue servicing their foreign currency 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

- amount of international reserves available for intervention in the foreign exchange market, particularly if the country's exchange rate is fixed, or for servicing external debt.
- level of import coverage provided by the country's international reserves. This metric refers to the number of months that the level of international reserves can cover the cost of the country's imports.
- type of financing, including reliance on foreign capital inflows (portfolio investments), which can be subject to quick reversals or sudden stops.
- importance of commodity exports as a source of revenue, the existence and reliability 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.
- 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

- access to international financial markets and the potential effects of a loss of market liquidity.
- relationships with private sector creditors, including the existence of loan commitments and the attitude among bankers toward further lending to borrowers in the country.
- 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.

- trend in direct foreign investments and the country's ability to attract foreign investment in the future.
- opportunities for privatization of government-owned entities.

Experience has highlighted a number of other important macroeconomic considerations that can affect country risk, including

- government's management of the economy and whether there are any significant imbalances, such as a large and growing fiscal deficit.
- condition of specific industries or sectors that dominate economic activity, for example, real estate and construction or export-oriented manufacturing.
- level and structure of domestic debt for both the public and private sectors.
- degree to which the economy of the country may be adversely affected by contagion from problems in other countries.
- 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.
- extent of prolonged rapid banking system growth and the potential for inflated asset values.
- 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.
- magnitude to which macroeconomic conditions and trends may have adversely affected the credit, liquidity, price, and other risks associated with counterparties in the country.

## Social, Political, and Legal Climate

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

- stability of the government in running the country's affairs over time, including during elections and transfers of power.
- degree to which political or regional factionalism or armed conflicts are adversely affecting government of the country.
- potential for social unrest, due, for example, to political upheaval, economic distress, and natural calamities.
- reliability and transparency of the country's legal system to fairly protect the interests of foreign creditors and investors and to control and limit corruption and significant changes to the legal framework of a country or region that may affect the interests of foreign creditors and investors.
- strength and sophistication of the country's financial regulatory system.
- adherence to international legal and business practice standards, including the Basel Core Principles for Effective Banking Supervision.

- adherence to the Financial Action Task Force (FATF) recommendations.<sup>26</sup>
- adherence to international accounting standards and the reliability and transparency of financial information.
- willingness and ability of the government to recognize economic or budgetary problems and implement appropriate remedial action.
- trends toward and likelihood of government-imposed price, interest rate, or exchange controls.
- extent to which the country's laws and government policies protect parties in electronic transactions and promote the development of technology in a safe and sound manner.
- extent of the country's natural and human resource potential.
- extent to which government policies promote the effective management of the institution's exposures.

## Bank-Specific Factors

Finally, the analysis of country risk should take into consideration factors relating to the nature of the bank's actual (or approved) exposures and funding in the country, including, for example,

- the bank's governance framework, span of control, legal entity structure, business strategy, and risk management plans for the country.
- the bank's mix of exposures and commitments, including the types of investments and borrowers, the distribution of maturities, the types and quality of collateral, the existence of guarantees, whether exposures are held for trading or investment, and any other distinguishing characteristics of the portfolio.
- the type, mix, and sources of in-country funding, including reliance on short-term, high-cost, or borrowed funds, and sources of contingency funds.
- the economic outlook for any specifically targeted industries within the country.
- legal, secrecy, consumer protection and suitability, and compliance restrictions.
- the degree to which political or economic developments in a country are likely to affect the bank's chosen lines of business in the country.
- susceptibility to changes in value based on market movements. As the market value of claims against a foreign counterparty rise, the counterparty may become less financially sound, thus increasing the risk of nonpayment. This is especially true with regard to derivative instruments.
- the scope of political or economic developments and the potential adverse impact on the credit risk of individual counterparties in the country. For example, foreign counterparties with healthy export markets or whose business is tied closely to supplying manufacturing entities in developed countries may have significantly less exposure to the local country's economic disruptions than do other counterparties in the country.
- the institution's ability to effectively manage exposures in a country through in-country or regional representation, or by some other arrangement that ensures the timely reporting of, and response to, any problems.

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<sup>26</sup> The FATF recommendations are available on the [FATF's Web site](#).

## Appendix B: Sample Request Letter Items

1. Current organization chart, with a brief description of individual responsibilities and résumés of key personnel.
2. List of key country risk committees with memberships and titles, and copies of mission statements and meeting minutes.
3. Board, committee, and senior management reports pertaining to country risk for [time period].
4. Board and committee meeting minutes dealing with country risk matters for [time period].
5. Audit and credit review reports, management responses, and follow-up reports.
6. Reports on compliance with foreign laws and regulations.
7. Country risk management policies and procedures.
8. Strategic and business plans for international business activities.
9. List of products, services, and business initiatives.
10. List of offshore operations and critical foreign third-party relationships.
11. Risk assessment reports.
12. Expected and unexpected loss analysis.
13. Country watch lists, and early warning metrics and analysis.
14. Due diligence and risk assessment for newly developed products and services.
15. Key MIS such as country exposure reports, concentration reports, trend and growth reports (by country, region, sector, and product), exposures of sovereigns to legal lending limits (12 CFR 32.5(f)), including off-balance-sheet items, and
  - distribution of exposures across country risk rating categories.
  - distribution of exposures by line of business.
  - country exposure trend analysis.
  - commitments, including type, amount, and level of expected usage.
  - type, mix, and sources of local, in-country funding sources.
16. Country risk analyses and rating reports.

17. Country and cross-border limits and a description of how they are calculated and measured. Describe types of cross-border mitigants (ring fencing, protective language, and insurance) with calculations.
18. Country and cross-border limit exception reports and escalation processes.
19. Results, documentation, and validation of models, stress tests, and scenario analyses of foreign exposures.
20. Form FFIEC 009 Country Exposure Reports for [time period] and related work papers.

## Appendix C: Glossary

**Allocated transfer risk reserve (ATRR):** The ATRR is the reserve that U.S. banks are required to establish against the risks presented in certain international assets subject to transfer risk. The value of these assets has been found by the ICERC to have been significantly impaired by the protracted inability of public or private obligors in a foreign country to make payments on their external indebtedness or no definite prospects exist for the orderly restoration of debt service. The bank must segregate the ATRR from the bank's allowance for loan and lease losses (ALLL), deduct it from gross loans, and not include it as part of bank capital. The alternative to establishing an ATRR is a direct charge to the ALLL or a reduction in the principal amount of the asset by applying interest payments or other collections on the asset.

**Basel Core Principles for Effective Banking Supervision:** The Basel Core Principles for Effective Banking Supervision are the de facto minimum standard for sound prudential regulation and supervision of banks and banking systems. Originally issued by the Basel Committee on Banking Supervision in 1997, they are used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying future work to achieve a baseline level of sound supervisory practices. The principles are also used by the International Monetary Fund and the World Bank, in the context of the Financial Sector Assessment Program, to evaluate the effectiveness of countries' banking supervisory systems and practices.

**Contingency plan:** A contingency plan addresses possible actions to take if political or economic conditions seriously deteriorate in countries where the bank has exposure.

**Convertibility risk:** The risk that the ultimate source of repayment is unable to convert its local currency into the foreign currency of payment.

**Country risk:** The risk that economic, social, and political conditions and events in a foreign country will affect the current or projected financial condition or resilience of a bank.

**Country risk analysis:** The process by which a country risk rating is assigned, including comprehensive analysis, use of models, stress testing, and contingency planning.

**Country risk rating:** Reflects the level of risk from economic, political, and social risks to a bank's business activities in a foreign country and its foreign exposures. The criteria for assigning each rating should be clear and precisely defined using objective, quantitative, and qualitative factors. 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 bank's appetite for risk.

**Country strategy:** Comprehensive plan for doing business in a particular country, including overall business strategy, risk appetite, growth and expansion plans, risk mitigation,

contingency plans, market share, product and service offerings, capital allocation, risk assessments and ratings, exposures and limits, regulatory risk, and legal framework.

**Cross-border risk:** The risk that arises when an office of a bank, regardless of its location or currency, has assets or liabilities that are located outside its national border.

**Form FFIEC 009 (Country Exposure Report):** Form FFIEC 009 provides information on the distribution, by country, of claims on foreign residents held by U.S. banks (national banks, federal savings associations, and federal branches and agencies) and bank holding companies (bank holding companies and savings and loan holding companies). The data collected are used for supervisory purposes and to assess transfer and related risks, such as country risk. The data are also aggregated and released to the public for analysis of the transfer and related risks in the United States' banking system.

**Interagency Country Exposure Review Committee (ICERC) ratings:** The ICERC ratings focus on whether the quality of an institution's international assets—subject to transfer risk—has been impaired by a protracted inability of public or private obligors in a foreign country to make payments on their external indebtedness and whether no definite prospects exist for the orderly restoration of debt service. The ICERC risk rating is the minimum risk rating applicable to all other cross-border and cross-currency exposures of U.S. banks in a reviewed country.<sup>27</sup>

**Ring fencing:** Measures taken by local regulators to protect the local depositors. These measures could include limiting the amount of excess funds that a foreign entity can remit out of the country.

**Sovereign default:** Sovereign default occurs when a country is not complying with its external debt-service obligations or is unable to service the existing loan according to its terms, as evidenced by failure to pay principal and interest fully and on time, arrearages, restructuring, or rollovers.

**Sovereign risk:** Sovereign risk is the sovereign (or government) obligor's likelihood of defaulting on its financial obligations.

**Stress tests:** Stress tests are exercises used to conduct a forward-looking assessment of the potential impact of various adverse events and circumstances on a banking organization. All banking organizations should have the capacity to understand their risks and the potential impact of stressful events and circumstances on their financial condition.<sup>28</sup> The stress testing practices should be commensurate with each bank's size, complexity, and sophistication. The stress testing process also should include risk mitigation or contingency plans to reduce the bank's exposures or, if necessary, to exit a country.

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<sup>27</sup> Refer to Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation, "Guide to the Interagency Country Exposure Review Committee Process," November 2008.

<sup>28</sup> OCC Bulletin 2012-14, "Interagency Stress Testing Guidance."

**Transfer risk:** The possibility that an asset cannot be serviced in the currency of payment because of a lack of, or restraints on, the availability of needed foreign exchange in the country of the obligor.

**Wrong-way risk:** Specific wrong-way risk arises when the exposure to a particular counterparty is positively correlated with the probability of default of the counterparty itself because of the nature of the transactions with the counterparty. General wrong-way risk arises when the probability of default of counterparties is positively correlated with general market risk factors. Wrong-way risk is an important aspect of counterparty credit risk that has caused major losses at banks.



## Appendix D: Abbreviations

<b>ALLL</b>	allowance for loan and lease losses
<b>ATRR</b>	allocated transfer risk reserve
<b>EIC</b>	examiner-in-charge
<b>FATF</b>	Financial Action Task Force
<b>FFIEC</b>	Federal Financial Institutions Examination Council
<b>ICERC</b>	Interagency Country Exposure Review Committee
<b>ICQ</b>	internal control questionnaire
<b>MIS</b>	management information system
<b>OCC</b>	Office of the Comptroller of the Currency

# References

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## Laws

- 12 USC 84(a), “Lending Limits” (national banks)
- 12 USC 1464(u), “Limits on Loans to One Borrower” (federal savings associations)
- 12 USC 3901 et seq, “International Lending Supervision” (national banks)

## Regulations

- 12 CFR 28.50, “International Lending Supervision” (national banks)
- 12 CFR 28.52, “Allocated Transfer Risk Reserve” (national banks)
- 12 CFR 32, “Lending Limits”
- 12 CFR 32.5(f), “Lending Limits, Loans to Foreign Governments”

## Comptroller’s Handbook

### Examination Process

- “Bank Supervision Process”
- “Community Bank Supervision”
- “Federal Branches and Agencies Supervision”
- “Large Bank Supervision”

### Safety and Soundness, Asset Quality

- “Concentrations of Credit
- “Trade Finance and Services”

### Safety and Soundness, Management

- “Internal and External Audits”
- “Internal Control”

## OCC Issuances

- Banking Circular 216, “Securities Denominated in Foreign Currencies” (September 11, 1986) (national banks)
- The Director’s Book* (October 2010) (national banks)
- OCC Bulletin 2002-10, “Country Risk: Sound Risk Management Practices” (March 11, 2002) (national banks)
- OCC Bulletin 2002-16, “Bank Use of Foreign-Based Third-Party Service Providers: Risk Management Guidance” (May 15, 2002)
- OCC Bulletin 2009-8, “Country Risk: Changes to the Interagency Country Exposure Review Committee Process” (March 4, 2009)
- OCC Bulletin 2011-12, “Sound Practices for Model Risk Management” (April 4, 2011)
- OCC Bulletin 2012-14, “Interagency Stress Testing Guidance” (May 17, 2012)

OCC Bulletin 2012-33, “Community Bank Stress Testing: Supervisory Guidance” (October 18, 2012)  
OCC Bulletin 2013-13, “Market Risk Capital Rule: Clarification of the Treatment of Certain Sovereign and Securitization Positions” (May 10, 2013)  
OCC Bulletin 2013-29, “Third-Party Relationships: Risk Management Guidance” (October 30, 2013)

## **Other**

Basel Core Principles for Effective Banking Supervision  
*FFIEC Information Technology (IT) Examination Handbook*  
Financial Action Task Force, “FATF Recommendations 2012”  
*Guide to the Interagency Country Exposure Review Committee Process* (November 2008)