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RMA'S COUNTRY RISK SURVEY THE RESULTS ARE IN

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The RMA Market Risk Council's recent survey offers valuable insight into how institutions are managing country risk in light of the political, economic, and regulatory events of the past year. This report is an executive summary of the findings.

Country risk dominated the international scene in 2013, a year highlighted by unrest in the Middle East, turmoil in Russia, and an economic slowdown in China. RMA conducted a survey last fall to help members understand how the industry is responding to these challenges and to reveal the practices and standards used to manage the country risk of financial institutions in North America, Europe, Asia, the Middle East, Africa, and Australia. The survey responses, in addition to providing benchmark data, show how country risk management has changed in response to recent global developments.

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The Country Risk Management Survey focused on the quantitative and qualitative tools used to monitor country risk and the impact that the recent sovereign crises have had on institutions’ approaches to managing country risk. It also addressed how institutions determine country limits and which characteristics are used to monitor and measure exposure. Finally, respondents were asked to comment on the trends they thought were likely to shape country risk management over the next three to five years.

The report of the survey’s findings contains a detailed statistical analysis of the responses received from the 48 participating institutions and analyzes the survey results according to the following categories:

- Country risk organizational structure and governance.
- Country risk monitoring tools and reporting.
- Country and sovereign risk ratings.
- Country risk appetite and limits.
- Country exposure measurement.
- Sovereign loss given default.
- Country ratings exercise.

Country Risk Organizational Structure and Governance

Country risk is a key issue for financial institutions. More than nine out of 10 have a specific unit dedicated to its assessment, and many expect that function to grow. The units average six employees, with functions split according to geographies and/or specific functions, and they are typically located in local offices.

Groups covering country and sovereign risk can be distinct, but 80% report to the risk department (chief credit officer, chief risk officer, or risk group). In 11% of institutions, the country risk teams report to the business lines. Most country risk teams rely on resources from other teams.

Their role is not limited to assessment and monitoring of risk factors. Country risk teams at two-thirds of surveyed institutions intervene in transaction decisions. Together with other risk managers and members of business lines, they often participate on the country risk committee, which decides country limits and risk ratings and is involved in strategy discussions. Country risk committees are absent in one-third of institutions.

Country Risk Monitoring Tools and Reporting

The survey suggests that banks typically use a combination of country risk monitoring tools. Over half of the responding institutions said they use a combination of seven tools. Most (80%) monitor country risk using qualitative country risk reports, while just under 70% employ market-based risk monitoring (such as CDS spreads) and external agency ratings, and 57% use quantitative country risk tools for monitoring. Over half (57%) monitor country risk through in-country visits. Finally, 57% use country risk watch lists, likely based on a combination of risk monitoring approaches.

Other significant country risk monitoring tools include the use of sanctions and anti-money-laundering monitoring, sovereign probability-of-default assessment tools, market openness monitoring, and early warning tools (each used by over 40% of respondents).

More than 80% of the institutions surveyed regularly share reports on country exposure, country limits, and country risk analysis with senior management. More than half produce country risk analyses and reports on a yearly basis, while 48% perform country-specific stress tests.

Country and Sovereign Risk Ratings

The structure and complexity of an institution’s country and sovereign risk rating system are a function of its product mix, level of international presence, and existing risk architecture.

The vast majority (88%) of institutions that participated in the study assign country risk ratings, slightly fewer (73%) assign sovereign ratings, and a little over two-thirds assign both sovereign and country ratings. Of those institutions that assign both country and sovereign risk ratings, more than half noted that the ratings are related.

The most common practices in assigning country risk ratings include using a scorecard model with weighted factors, benchmarking to external rating agencies, or a combination of approaches. Roughly half of institutions that assign sovereign risk ratings calculate them by benchmarking to external agency ratings. Most of those who use external agency ratings as a benchmark for their internal risk measures use the long-term foreign currency ratings given by the three major rating agencies: S&P, Moody’s, and Fitch. Almost two-thirds of institutions surveyed apply a time horizon of greater than one year to their internal ratings, and about half apply a horizon of one to two years.

When asked how their institutions' sovereign risk ratings compare to those of the rating agencies, over half indicated that their ratings are consistent for some countries but inconsistent for others. Only one institution indicated that its internal ratings were generally rated better than those of the rating agencies.

While almost three-quarters of financial institutions surveyed have a proprietary country or sovereign risk model, the type and number of models used by a firm vary greatly. Some have both sovereign probability of default (PD) and country risk rating models. Others have models to produce sovereign PDs and loss given defaults (LGDs), as well as country risk ratings and transfer and convertibility risk ratings. Still others may have only a country risk model.

The different approaches to risk measurement used by the study participants reflect the wide range of business models of the participating institutions.

Country Risk Appetite and Limits

Since the global financial crisis, a focus across the industry has been on improving risk governance through the development of risk appetite statements. About 75% of financial institutions surveyed have a formalized country risk appetite statement, which is most commonly employed for setting country limits, capping overall country exposure, or analyzing broader strategic considerations such as determining international allocations. Certain institutions also reported using their risk appetite statement to set country limits by product, region, or country risk rating.

In addition to the overall level of country risk, the most common factors considered when setting country limits include the country's relative size by GDP or financial market, the planned usage of the limit, and the previous utilization of the limit. Most institutions (78%) reported that they also set country sublimits, which are most often categorized by type of exposure, tenor, or counterparty type.

There is no common standard for the governance of the country risk appetite statement. The country risk committee, other management-level risk committees, the CRO, and board of directors are all commonly cited as approvers of the country risk appetite statement and limits. However, almost 90% of institutions surveyed have established protocols and escalation procedures in cases where country limits are unexpectedly breached.

Country Exposure and Measurement

Almost all participating banks (84%) report the cross-border exposures in their country risk measurements. Around 60% also include potential future exposures for derivatives and/or market or notional value of bonds or other loans. A large majority report per country of risk, although some report per country of residence as well. Banks using the country of risk will use the country of residence as a default when the country of risk is not available, such as for funds that invest in multiple jurisdictions. When the country of risk is not clear, 45% of reporting banks base their allocation on a best-estimate proportion of exposure and 11% allocate the risk to the country with the largest exposure.

Almost all banks factor in mitigations when reporting their country exposures: 82% guarantees, 72% collateral, and 67% export credit agencies. The survey and subsequent round table discussions revealed that some institutions are double counting or reporting on a gross and net basis.

Just half of the reporting banks must have some exposures included manually, while 34% have a completely automated system.

Sovereign LGD

The survey and discussion during the RMA Country Risk Round Table held in November 2013 in Paris suggest that sovereign LGD is not a priority for most institutions, with the exception of institutions regulated by the Financial Services Authority in the United Kingdom. With the exception of the U.K., regulators are not putting pressure on sovereign LGD for the moment. The survey results suggest a lack of clear methodology and guidance for sovereign LGD. Almost half (43%) of the respondents use a combination of model and judgment.

The lack of historical default creates a difficulty, and no clear methodology is appearing throughout the industry. The result is that some regulators (the U.K.'s Prudential Regulation Authority) are putting the floor at 45% for all sovereigns. The methodologies used by respondents refer to different elements, such as sovereign PD, corporate experience, rating agencies, and historical data.

Almost half of those surveyed (43%) have a granular approach, with a different LGD for each country, while others split countries into buckets of LGD per market, per type of country, or per ratings.

As the judgmental layer is key to the final output, LGD levels vary from one institution to another, with a few saying they use the standardized approach. The discussion has also revealed the difficulty of differentiating the indicators used for LGD from those used for PD and that there is no history of default for the better-rated countries. ❖

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