

Policy Statement on Country Risk Management

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Please refer to the Thai text for the official version.

Bank of Thailand Policy Statement
RE: Policy Statement on Country Risk Management

1. Rationale

Nowadays, commercial banks have granted credits, made investment or undertaken contingent liabilities with non-residents to a greater extent, increase the number of their overseas branches and have more transactions with overseas counterparties. The Bank of Thailand (BOT) therefore deems that the Policy Statement on Country Risk Management should be stipulated so that commercial banks will have a system to protect themselves against country risk and transfer risk as well as have adequate and appropriate provision for buffering any adverse effects that may arise from such transactions.

The essence of the rule under this policy statement has not been altered, aside from an additional stipulation for commercial banks to take into consideration indirect country risk in order that the country risk management will reflect real risk. Nevertheless, in case where the commercial banks are not ready for indirect country risk management, they are allowed to carry out the adjustment for 1 year from the day this policy statement comes into force.

2. Scope of Application

This policy statement shall apply to all commercial banks under financial institutions businesses law, which have overseas branch or have the ratio of total overseas credits, investment, and contingent liabilities to their tier 1 capital of 50 percent or more for the commercial banks registered in Thailand, or hold 50 percent or more of their assets under Section 32 of the Financial Institutions Business Act B.E. 2551 for branches of foreign banks.

3. Repealed Notification and Circular

Circular Letter No.: ThorPorTor. ForNorSor. (21) Wor. 240/2549 dated 23 February 2006 Re: Policy Statement on Country Risk Management shall be repealed.

4. Contents

4.1 In this policy statement

“Country risk” means the risk that arises from uncertainties in economic, social, and political factors or other external conditions such as natural disaster, social or political unrest of the countries in which commercial banks have granted credits,

made investment, or undertaken contingent liabilities with residents of those countries in such a way that affects the level of risk or creditworthiness of business undertaking in those countries. Such may cause commercial banks' debtors or counterparties to be unable to repay their debts or decline to fulfill their contractual obligations and may affect the financial status and operations of the commercial banks.

Five significant country risk types are as follows:

(1) Sovereign Risk means the risk those commercial banks' sovereign borrowers or counterparties are unable or unwilling to repay their debts, or refuse to fulfill their contracts or obligations either directly or indirectly, such as debt moratorium policy.

(2) Transfer risk means the risk that non-resident counterparties are unable to secure foreign exchange to repay their debts to the commercial banks due to certain restrictions, for example, when the host country government imposes the capital control or foreign exchange control measures.

(3) Contagion Risk means the risk that arises when changes in certain factors in one country affects other countries in the region whose residents are bank's counterparties, for example, downgrading of credit rating of one country has an effect on debt repayment or business undertaking with residents in other countries in the same region.

(4) Macroeconomic Risk means the risk that arises when non-resident counterparties are unable to or do not repay their debt or are unable to fulfill their obligations as a result of changes in economic policies of their countries, i.e., raising interest rates to preserve currency value or changes in tax policy.

(5) Indirect Country Risk means the risk that arises from uncertainties in economic, social, political or other external factors in other countries which cause significant impacts to the Thai debtors' ability to repay their debts. Nevertheless, in case where the commercial banks are not ready for indirect country risk management, they are allowed to carry out the adjustment for 1 year from the day this policy statement comes into force.

4.2 Rules

4.2.1 Roles and responsibilities of board of directors and senior management

The Board of Directors and senior management of commercial banks shall govern country risk management. At the minimum they should undertake the following roles and responsibilities:

(1) Roles and responsibilities of Board of Directors

(1.1) Ensure that strategy is established and approve policy, plan and procedure for country risk-related transactions

(1.2) Regularly review and assess strategy and policy on country risk-related transactions in accordance with size and complexity of transactions or whenever the board of directors and executives deem appropriated. This is to ensure that the policy, plan and procedure are in line with the strategy, acceptable level of risk, and anticipated returns, as well as reflect changes from the economic conditions and environment.

(1.3) Approve and review credit line or exposure limit of transactions related to each country.

(1.4) Ensure that senior management stipulate adequate and appropriate risk management policy and internal control for country risk-related transactions .

(2) Roles and responsibilities of senior management

(2.1) Establish risk management policy, procedures and internal control for country risk-related transactions , as well as credit line and exposure limit for transactions in each country in coherence with commercial banks' financial status and operation for the Board of Directors' approval and putting into effect.

(2.2) Allocate adequate resources and staffs to support the system of country risk management as well as assign responsible and authorized persons to approve country risk-related transactions. The persons authorized to approve such transactions should be independent from those responsible for setting the credit lines and supervising transactions related to each country.

(2.3) Communicate and circulate the strategy, policy, plan, and procedures for country risk-related transactions to all relevant staffs so that they are informed and comply with rigorously, as well as arrange adequate training for relevant staffs on a regular basis.

(2.4) Reviewing relevant policies at least once a year and every time there are material changes to the strategy and environment.

4.2.2 Country Risk Management Policy

(1) Commercial banks should establish clear and written policy on country risk management which is approved by the bank's board of directors. Such policy may be part of the credit risk management policy, such as large exposure limit, classification and provisioning, etc.

(2) Commercial banks should establish policy and procedures for country risk management in accordance with the nature, amount, and complexity of the transactions by taking into account the potential risks, anticipated returns, capital adequacy, provisions against potential risks, and readiness of the system and staffs. The risk management policy and procedures should include the following characteristics:

(2.1) delegation of duties and responsibilities regarding risk management, as well as approval of transactions related to each country;

(2.2) type of country risk that may incur, and the policy and procedures to manage each type of risk;

(2.3) risk assessment system that includes analysis criteria, risk measurements and risk rating of country risk-related transactions ;

(2.4) risk control system that comprises the policy on setting credit line or exposure limit for each country, classification and provisioning policy, and collateral policy, as well as policy on preparing and assessing completeness of documents and credit contracts that should be in accordance with appropriate laws in each country;

(2.5) risk monitoring system that monitors counterparty countries' situation, reporting system of transactions related to each country, internal control system, and stress test.

4.2.3 Risk Assessment

Commercial banks should have a system to analyze, to measure potential risks from transactions related to each country as well as to rate risk as follows:

(1) Risk Analysis

(1.1) Commercial banks should have a system to monitor the economic, social and political conditions of each counterparty country and should analyze the country risk from undertaking transactions related to each country at least once a year or more, depending on the size and complexity of the transaction. Commercial banks should take into account both quantitative and qualitative factors while analyzing the country risk.

(1.2) The quantitative factors that commercial banks should take into account include the amount of transactions conducted with each type of debtors such as sovereign debtor , commercial bank debtor and corporate debtor, etc., the remaining maturity of each contract, the amount of off-balance sheet items that commercial banks have to fulfil their future obligations such as derivatives transactions, etc. along with the economic factors of each counterparty country such as exchange rate, inflation rate, interest rate, public debt, short-term debt, GDP growth, unemployment rate, liquidity factors, government's capability in generating revenue, and other relevant statistics.

(1.3) The qualitative factors that commercial banks should take into account include the economic, social and political stability in each country, the monetary policy, the foreign exchange control measure, the transparency of information, the financial and market structure, such as commercial banks' supervision policy of the supervisory authority in that country, the legal system, and the accounting standards.

(1.4) Commercial banks should monitor the changes in government's policy and strategy of each country that they have exposures with in

order to assess the potential effects from such changes, for example, such changes may reduce debtor's repayment ability in certain business sectors. The banks should also revise the policy on country risk-related transactions with such country in an appropriate and timely manner. They should also establish appropriate contingency plan to cope with certain circumstances in each country, for instance, increase frequency of monitoring and assessment and expand scope of assessment.

(1.5) Commercial banks should prepare documentation and summary of the risk analysis of each country to present to the senior management so that it can be used for decision making and revising of the policy on country risk-related transactions and the associated strategies accordingly.

(1.6) Commercial banks should allocate staffs and resources for country risk analysis in accordance with the size and complexity of the banks' transactions.

(1.7) Commercial banks should verify the analytical system in order to obtain the results from the country risk analysis and compare it with those from the other sources, including the information from researches and credit rating of external credit rating agencies.

(2) Risk Measuring

(2.1) Commercial banks should establish a system to measure potential risks from country risk-related transactions by taking into consideration the quantity of risk that may incur to commercial banks and their branches. In addition, they should take into account the size and complexity of the transactions.

(2.2) Commercial banks should measure risk by country of residence of the debtor or his counterparties.

(2.3) Commercial banks should have a system to measure counterparties' debt exposures by type of transaction, such as foreign exchange contracts and interest rate contracts. Such a system should provide sufficient detailed information for risk measurement and risk analysis of transactions related to each country such as type of borrower, debt obligation, collateral, and remaining maturity, etc.

(3) Risk Rating

(3.1) There are 2 approaches for rating the risk of transactions related to each country:

(3.1.1) Risk rating by external credit rating agencies such as Standard & Poor (S&P), Moody's, or Fitch, which can be categorized by type of financial instrument such as short-term and long-term or by type of counterparty such as sovereign and juristic person;

(3.1.2) Risk rating by commercial banks which is conducted by summarizing the results from the analysis and assessment of various factors by region, country, type of transaction and currency. A good risk rating by commercial banks should clearly segregate risk levels and be comparable with the risk rating of external credit rating agencies.

(3.2) Commercial banks should use their own risk rating along with the risk rating of external credit rating agencies.

(3.3) Commercial banks should set clear procedures and factors for country risk rating. There should be staff responsible for country risk rating who have knowledge and expertise, and work independently on risk rating from those responsible for approving country risk-related transactions.

(3.4) Commercial banks should conduct risk rating at least once a year and should review the rating whenever there are material changes in economic, social and political conditions in the counterparty countries.

(3.5) Commercial banks should use the risk rating in setting appropriate credit lines or country exposure limits as well as in classifying and provisioning for transactions related to each country. For example, if the commercial bank's risk rating of a country is high, the bank should consider classifying and provisioning for debtors from such a country at a higher rate than normal.

4.2.4 Risk Controlling

(1) Setting Credit Line or Exposure Limit

(1.1) Commercial banks should have a system to set a credit line or exposure limit for transactions related to each country. The country exposure limits should be approved by the banks' Board of Directors and must be reviewed at least one a year or more according to the size and complexity of the transactions or whenever there are material changes in economic, social and political conditions in that country.

(1.2) Commercial banks should set the exposure limits on country risk related transaction in accordance with the banks' overall strategy and policy, capital adequacy and provisions for potential risks, risk rating of each country, acceptable level of risk, and business opportunities in each country.

(1.3) Commercial banks should set multi-level of country exposure limits, in addition to the overall limits, for example, setting limits by region, type of business, type of counterparty, currency, type of transaction and collateral.

(1.4) Commercial banks should assign the responsible person for setting the country exposure limits who should be independent of those responsible for approving country risk-related transactions.

(1.5) Commercial banks should clarify the country exposure limits to all relevant staffs so that they are informed and comply with rigorously. The limits can be varied by management level of commercial banks, for example, an approval limit for an overseas branch manager.

(2) Classification and Provisioning

(2.1) Commercial banks should set clear written policy on classification and provisioning, and obtain approval from the banks' Board of Directors. The policy should cover both domestic and international transactions and

reflect the credit risk of the counterparty countries and the overall fundamental risk of each country.

(2.2) Commercial banks should set different provisioning policy for different countries according to the economic, social and political conditions related to each country by analyzing the problems of each country and severity of the problems, estimating potential losses in that country, and setting aside additional provisions for the potential losses.

(2.3) Commercial banks should assign appropriate person with authority, duty, and responsibility in considering an appropriate level of provisioning for each counterparty country.

(2.4) Commercial banks may choose to make provision against country risk by country or by debtor as it is deemed appropriate.

(2.5) Commercial bank may not need to make provision against country risk specifically if the current level of existing provision is already sufficient for both credit risk and country risk.

(2.6) Commercial banks should prepare appropriate documents and supporting reasons used in considering making provision against country risk. If it is deemed material, commercial banks should consult relevant persons such as the banks' Certified Public Accountants (CPA).

4.2.5 Risk Monitoring

(1) Monitoring Situations

(1.1) Commercial banks should have a system to monitor economic, social and political circumstance on a regular basis.

(1.2) Commercial banks should establish a system to specifically monitor compliance to the country risk management policy of relevant staff in the aspects of limits for overseas credits, investment and contingent liability with counterparty country. The banks should monitor the transactions once a month. However, if the banks grant credit, make investment or undertake contingent liability in a large amount, the monitoring should be conducted more often as it deems appropriate.

(1.3) Commercial banks should collect information from external credit rating agencies as well as periodically review and monitor outstanding debt of counterparty countries.

(1.4) Commercial banks should keep regular contacts between senior management and managers of overseas branches and should have a contingency plan in case the counterparty countries face economic, social or political crisis

(1.5) Commercial banks should monitor the structure and quality of credit portfolios and other transactions in counterparty countries in order to

monitor the concentration of each type of transaction such as granting credits to a particular industry sector.

(2) Reporting

(2.1) Commercial banks should have a reliable system to gather risk information and categorize type of country risk

(2.2) Commercial banks should have a reliable reporting system with adequate detailed information covering all aspects of country risk-related transactions. This is to enable the senior management to be aware of actual country risk position and to review the country risk policy of each country, and identify exceptions in conducting transactions in a timely manner.

(2.3) Commercial banks should regularly notify the Board of Directors of information regarding country risk-related transactions. In the case that the risk reach a significant level, the banks should notify the Board of Directors at least on a quarterly basis and should increase the frequency of notifying as the transactions involve higher risk and may affect financial status and operation of the bank

(3) Inspection and Internal Control

(3.1) Commercial banks should have appropriate internal control system for country risk management process and should have adequate tools or methods to verify accuracy of data, as well as allocate staff and units with necessary skills to be responsible for country risk-related transactions.

(3.2) Commercial banks should have a sound internal control system, for example, the bank should separate persons responsible for undertaking international transactions from those responsible for analyzing the country risk, and segregate the duties between those responsible for risk rating and those approving the country exposure limits.

(3.3) Before accepting any assets as collateral for the country risk related transaction, commercial banks should ensure that the collateral is in full compliance with relevant laws and regulations, liquid, and enforceable under the laws of that country.

In case where commercial banks have collateral that are immovable properties such as land and building, the banks should ensure that they are able to mortgage and have real right over that collateral. In this respect, the banks should have or hire lawyers with expertise in laws, regulations and practices in that country to check legitimacy and enforceability of the loan agreements, guarantees and other documentations.

(3.4) Commercial banks should invest in securities with investment grade which is rated by external credit rating agencies such as Standard & Poor's (S&P) Moody's or Fitch or securities traded in security exchanges or securities trading centers supervised by an agency that is an ordinary member of International Organization of Securities Commissions (IOSCO) or securities traded in international

Security Exchange Market which is a member of the World Federation of Exchange (WFE)

(4) Stress Test

(4.1) Commercial banks should conduct stress test for country risk according to the amount of transactions or size of risk of each country in order to estimate potential losses that may incur from each counterpart country. The result obtained from the test should then be taken into account in assessing adequacy of capital funds and provisioning.

(4.2) Commercial banks are not required to have a sophisticate financial model for the stress test for their country risk. However, the bank should be able to assess potential impact from country risk in various circumstances

(4.3) In conducting stress test, the banks should perform covariance analysis in order to verify the contagion risk, especially for the countries in the same region.

(4.4) Commercial banks should review the results of the stress test on a regular basis and set up an appropriate procedures in case where the results of the test is over the acceptable level, to be used for establishing appropriate policy and credit line for each counterparty country accordingly.

(4.5) Commercial banks should report the results of the stress test to the Board of Directors and senior management.

5. Effective Date

This Policy Statement shall come into force from 4 August 2008 onwards.

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