

FEDERAL RESERVE BANK OF SAN FRANCISCO
101 MARKET STREET, SAN FRANCISCO, CALIFORNIA 94105

March 20, 2002

**BANKING SUPERVISION AND REGULATION:
COUNTRY RISK MANAGEMENT**

To State Member Banks
and Others Concerned
in the Twelfth Federal Reserve District

Interagency Guidance on Country Risk Management (SR 02-5)

The Federal Reserve, along with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, have issued enhanced guidance concerning the elements of an effective country risk management process for banking organizations. Country risk is the risk that economic, social, or political conditions in a foreign country might adversely affect an organization's financial condition, primarily through impaired credit quality or transfer risk.¹

The interagency guidance, which is attached to this letter, builds in part on the findings of a 1998 study by the Interagency Country Exposure Review Committee (ICERC) on the country risk management practices of U.S. banks (SR letter 98-33). This new guidance supplements and strengthens existing guidance with regard to country risk and is part of an ongoing effort by the agencies, through their participation in the ICERC, to ensure that banking organizations' management of risks arising from their international activities are appropriately and adequately addressed during the examination process.

Effective Country Risk Management

Country risk can occur in many different forms, and the nature of specific risks can change over time. It is essential that a U.S. banking organization with significant direct or indirect international exposure have in place an effective country risk management process that is appropriate to the volume and complexity of its international activities. Examiners should continue to evaluate the adequacy of the country risk management process at internationally active institutions and should augment their assessments using this new guidance. The interagency guidance makes clear that this process should include, at a minimum, the following:

- Effective oversight by the board of directors
- Adequate risk management policies and procedures
- Accurate country exposure reporting system
- Effective country risk analysis process
- Country risk rating system
- Limits to country exposure
- Ongoing monitoring of country conditions
- Periodic stress testing of foreign exposures
- Adequate internal controls and audit function

¹ Transfer risk, which is evaluated by the Interagency Country Exposure Review Committee (ICERC), is the possibility that an asset cannot be serviced in the country of payment because the obligor's country lacks the necessary foreign exchange or has put restraints on its availability. For more information, see the Guide to the Interagency Country Exposure Review Committee Process (SR letter 99-35).

An institution's country risk management process should give particular attention to any concentrations of country risk.

Indirect Country Risk Exposure

Country risk is not necessarily limited to institutions with direct international exposures. Domestic counterparties with significant economic dependence on a foreign country or region (for example, through export dependence) can pose indirect country risk to institutions that do not have direct international activity. While institutions are not required to incorporate indirect country risk into a formal country risk management process, they should nevertheless take these country risk factors into account, where appropriate, when assessing the creditworthiness of domestic counterparties. Examiners should ensure that the overall credit risk management process takes into account indirect country risk where applicable in all supervised institutions.

Additional Information

All circulars and documents are available on the Internet through the Federal Reserve Bank of San Francisco's Internet site, at <http://www.frbsf.org/banking/letters>. Paper copies of the Board's notice (**SR 02-5**) are available from our Corporate Services Department. To request copies to be sent by mail, please call (415) 974-2060.

For additional information about country risk management, please contact our Banking Supervision and Regulation Department at (415) 974-2911.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Attachment

Cross-reference: SR letters 99-35 and 98-33