



澳門金融管理局  
AUTORIDADE MONETÁRIA DE MACAU

Circular No. 008/B/2008-DSB/AMCM

(Date: 10/01/2008)

## **GUIDELINE ON MANAGEMENT OF COUNTRY RISK**

The Monetary Authority of Macao (AMCM), under the powers conferred by Article 9 of the Charter approved by Decree-Law no. 14/96/M of 11<sup>th</sup> March and by Article 6 of Financial System Act of Macao approved by Decree-Law no. 32/93/M of 5<sup>th</sup> July, establishes the following:

### **1. INTRODUCTION**

- 1.1 When authorized credit institutions engage in international lending or incur cross-border exposures (“international activities” hereinafter), they undertake not only the customary credit risk but also country risk, which is the risk associated with the economic, social and political conditions within a foreign obligator’s home country/jurisdiction. For instance, deteriorating economic conditions or political and social unrest in a foreign country may affect the ability of a borrower in that country to fulfill his obligations. The nationalization or expropriation of assets, government repudiation of external indebtedness, exchange controls, and currency depreciation or devaluation may also cause a borrower to be unable or unwilling to pay his external debts.
- 1.2 The AMCM is of the view that sound country risk management should be a part of the risk management framework of institutions that engage in international activities. Since institutions can exercise little direct influence on country risk, they should also avoid taking undue concentration risks on such exposures.
- 1.3 Accordingly, this Guideline provides guidance on the management of country risk. It applies to all authorized credit institutions either locally incorporated or being branches of overseas banks in Macao.
- 1.4 For the purpose of this Guideline, the reference to the term “country” should be widely interpreted to include different jurisdictions or economic entities. For example, institutions should treat the Mainland China, Hong Kong and Chinese Taiwan as separate jurisdictions / economic entities in their country risk management processes.



澳門金融管理局  
AUTORIDADE MONETÁRIA DE MACAU

## 2. TYPES OF COUNTRY RISK

2.1 Country risk may occur in different forms. The most common categories include:

- (a) Sovereign Risk. This denotes a foreign government's capacity and willingness to pay its direct and indirect foreign currency obligations. A government's capacity or willingness to repay may be affected by different reasons. For instance, one should remain alert on whether the repayment capacity of a country has been affected if that country appears or may appear on a watch list that have international implications.
- (b) Transfer Risk. The risk that the borrower or obligator may not be able to obtain the necessary foreign exchange to service its cross-border obligations (e.g. due to exchange controls).
- (c) Contagion Risk. The risk that adverse developments in one country may lead to, say, a downgrade of rating or a credit squeeze for other countries in the region, notwithstanding that those countries may be more creditworthy and that the adverse developments do not apply to them.
- (d) Currency Risk. The risk that a borrower's domestic currency holdings and cash flow become inadequate to service its foreign currency obligations because of devaluation.
- (e) Macroeconomic Risk. The risk that a borrower in a country may suffer from the impact of high interest rates due to measures taken by the government of that country to defend its currency. The government may also decide to nationalize or expropriate foreign assets.
- (f) Indirect Country Risk. The risk that may be posed by a domestic borrower whose ability to repay is dependent on the economic, social or political conditions in a foreign country that he has substantial business interests.

2.2 Institutions should be aware of the different types of country risk (including those categories of risks that are not listed in paragraph 2.1 above) to which they may be exposed and tailor their risk management framework accordingly. While institutions are not required to incorporate indirect country risk into a formal country-risk management process, they should take into account, where appropriate, the country-risk factor when assessing the creditworthiness of domestic borrowers.



澳門金融管理局  
AUTORIDADE MONETÁRIA DE MACAU

### 3. RISK MANAGEMENT PROCESS

- 3.1 To effectively control the risk associated with international activities, institutions should have a sound country risk management process. Such process should include effective oversight by the board of directors, adequate policies and procedures and other essential elements as set out under paragraphs 3.2 to 3.10 below.
- 3.2 *Oversight by the Board of Directors*<sup>1</sup>. The board of directors of an institution should be responsible for approving and periodically reviewing policies governing the institution's international activities to ensure that they are consistent with the institution's strategic plans and goals. The board is also responsible for approving and reviewing country exposure limits and ensuring that management of the institution is adhering to the policies and implementing appropriate measures to identify, monitor and control country risk.
- 3.3 *Policies and Procedures for Managing Country Risk*. The management of an institution is responsible for implementing sound, well-defined policies and procedures for managing country risk. The policies and procedures should set out:
- (a) the institution's business strategy in cross-border activities;
  - (b) the overall limits and sub-limits for cross-border exposures, including the authority to approve these limits and any exceptions;
  - (c) clear lines of responsibility and accountability for country risk management decisions;
  - (d) the standards and criteria to be used to analyze the risk of particular countries;
  - (e) the authorized activities, investments, and instruments; and
  - (f) the desirable and undesirable types of business.

Management should also ensure that the policies, standards, and practices are clearly communicated to the affected offices and staff.

- 3.4 *Country Exposure Reporting System*. Each institution must have a reliable system for capturing and categorizing the volume and nature of cross-border exposures. The reporting system should cover all aspects of the institution's operations. The report on the level of cross-border exposures should be provided to the board of directors regularly. Exposures to individual countries

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<sup>1</sup> In the case of branches of foreign incorporated institutions, the management at the head offices responsible for the operations of the branches.



澳門金融管理局  
AUTORIDADE MONETÁRIA DE MACAU

that exceed 30% of the institution's own funds should be reported to the board at least quarterly.

- 3.5 *Country Risk Analysis Process.* Institutions are expected to have an effective country risk analysis process to assess the risk associated with each country in which they are conducting or planning to conduct business, although the level of resources devote to the process may vary depending on the size and sophistication of an institution's international operations. In assessing the risk of a country, institutions should consider both the quantitative and qualitative factors of that country. For example, the size and structure of the country's external debt, the quality of the policy-making function, social and political stability and the legal and regulatory environment of the country. Institutions may make use of internal and external sources for assessing country risk but they should conduct their own country risk assessment instead of relying entirely on external assessment. During times of instability and impending crisis, institutions should update their analyses more frequently and expand the scope of their country risk analysis as necessary. The results of country risk analysis should be integrated closely with the process of formulating marketing strategies, approving credits, assigning country risk ratings (see paragraph 3.6 below), setting country exposure limits (see paragraph 3.7) and provisioning (see paragraph 4 below).
- 3.6 *Country Risk Ratings.* Institutions should have a system to integrate the results of their country risk analysis (see paragraph 3.5 above) into their internal assessment of repayment capability of borrowers. For those institutions that have significant<sup>2</sup> cross-border exposures, they should consider establishing a formal country risk rating system<sup>3</sup> to summarize the conclusions of the country-risk analysis process. Country risk ratings should be assigned at least annually to every country in which institutions have substantial<sup>2</sup> exposures. The ratings can provide a framework for establishing country exposure limits (see paragraph 3.7 below) that reflect the institution's tolerance for risk. They can also be used to determine the appropriate level of provisions for cross-border exposures (see paragraph 4 below).
- 3.7 *Country Exposure Limits.* Institutions should have a system for establishing, maintaining and reviewing country exposure limits, which usually reflect a balancing of the following considerations:

(a) the institution's overall strategy on international activities;

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<sup>2</sup> For the purpose of this Guideline, exposures to individual countries / jurisdictions that exceed 30% of an institution's own funds will be considered as significant / substantial.

<sup>3</sup> In a formal rating system, the country risk rating categories (e.g. numerical or alphabetical), the types of country risk and the types of exposures covered under each rating category should be clearly defined.



澳門金融管理局  
AUTORIDADE MONETÁRIA DE MACAU

- (b) the country's risk rating (see paragraphs 3.5 and 3.6 above) and the institution's appetite for risk;
- (c) the perceived business opportunities in the country; and
- (d) the desire to support the international business needs of domestic borrowers.

Country exposure limits should be approved by the board of directors, or a committee thereof, and communicated to all affected departments and staff. The limits should be reviewed and approved at least annually and more frequently when concerns about a particular country arise. Compliance with country exposure limits should be monitored at least on a monthly basis. In the case of any exception to approved country exposure limits, it should be properly authorized and reported to an appropriate level of management or the board so that it can consider corrective measures.

- 3.8 *Monitoring Country Conditions.* Institutions should have a system in place to monitor current conditions in each of the countries where it is significantly exposed. The level of resources devoted to monitoring conditions within a country should be proportionate to the institution's level of exposure and the perceived level of risk. The information gathered in this process should be properly maintained in the country risk analysis files. If the institution maintains an in-country office in the foreign country, a report from the local staff will be a valuable resource for monitoring country conditions. In addition, periodic visits by the regional or country manager to a country or to the borrowers' overseas production lines are also important to monitor country conditions or individual exposures. The communications between senior management and the responsible country managers should be regular and ongoing. There should also be procedures for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country.
- 3.9 *Stress Testing.* Institutions should periodically (e.g. monthly or quarterly<sup>4</sup>) stress test their foreign exposures and report the results to the board of directors and senior management. The testing should include, for example, an evaluation of the impact on an institution's country risk exposures under different scenarios. The level of resources devoted to this effort should be commensurate with the significance of foreign exposures in the institution's overall operations. The use of sophisticated financial modeling tools is not compulsory.

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<sup>4</sup> In the light of rapidly deteriorating economic / political condition in a country, an institution may need to conduct ad-hoc or more frequent stress test on the likely impact on its exposures to that country.



澳門金融管理局  
AUTORIDADE MONETÁRIA DE MACAU

- 3.10 *Internal Controls and Audit.* Institutions should ensure that their country risk management process includes adequate internal controls, and that audit mechanisms are available to ensure that the information for senior management and the board to monitor compliance with country-risk policies and exposure limits is true and accurate. As an example, the system of internal controls should ensure that the responsibilities of marketing and lending personnel are properly segregated from the responsibilities of personnel who analyze country risk, rate country risk, and set country limits.

#### 4. COUNTRY RISK PROVISIONING

- 4.1 Country risk provisions generally refer to provisions set aside by authorized credit institutions to absorb potential losses arising from its country risk exposures. There are two common approaches that institutions may adopt for country risk provisioning:
- (a) to earmark country risk provisions against the aggregate exposures to a particular country (i.e. on a country basis) after accounting for risk transfer and making specific provision against credit risk; and
  - (b) to factor in an element of provision for country risk into specific provisioning for each individual exposure (i.e. on an individual obligor basis).
- 4.2 Whichever approach is adopted, institutions should make sure that they have set aside adequate country risk provisions according to their assessment of the probability of losses arising from their cross-border exposures. They may not however need to make additional provisions solely for country risk if they are satisfied that the current level of specific and general provisions is already sufficient to absorb any potential losses due to both credit and country risks.
- 4.3 The criteria for when to provide and how to calculate country risk provision should be specified in the institutions' policies and procedures, which should also clearly indicate which party has the authority to decide the level of country risk provision. Where an institution has a formal internal country risk rating system, it should also clearly demonstrate how its country risk rating system (see paragraph 3.6 above) links up with its provisioning methodology.
- 4.4 Institutions are expected to establish the provisions for country risk in their own books. Institutions proposing to establish the provisions elsewhere are expected to first consult the AMCM. Nevertheless, the AMCM is prepared to accept the proposal for institutions incorporated outside Macao to establish country risk provisions in their overseas head offices, subject to valid



澳門金融管理局  
AUTORIDADE MONETÁRIA DE MACAU

confirmation from the head offices and, where appropriate, confirmation from the overseas supervisory authorities that the provisions are adequate.

**5. SUPERVISORY REVIEW**

- 5.1 Taking into account the size and complexity of an institution's cross-border exposures and other factors as set out in this Guideline, the AMCM will evaluate the adequacy of an institution's system to manage country risk and maintain provisions for such risk
- 5.2 The AMCM will from time to time conduct review on the level of country risk provisions made by individual institutions. On a case-by-case basis, it may require institutions to re-assess their country risk provisions if there are grounds to doubt whether their existing provisioning level is adequate.