Country Risk

Foreign lending by U.S. banks has attracted considerable attention in recent years. In the period preceding the adoption of flexible exchange rates, policy makers and economic analysts were primarily interested in the effects of international banking flows on the choice of fixed vs. flexible exchange-rate systems. But now, country risk has become a topic of importance because of heavy commercial-bank lending to less-developed countries (LDCs) and to the Socialist bloc countries. Indeed, this heavy financing has raised concern about the debt-servicing capacity of some borrowers.

Some press accounts have placed the debt figures of developing countries at about $180 billion, and have estimated credits to the Soviet Union and Eastern bloc countries at about $40 billion. U.S. bank loans to developing countries, after a rapid increase in the past three years, totalled about $45 billion at the end of 1976. In testimony before the Senate Banking Committee last week, Federal Reserve Chairman Arthur Burns said that the time had come for the OPEC nations “to live up to their responsibilities” by becoming bankers to the debt-ridden developing countries. He called for a strong cooperative effort among OPEC nations, LDCs, international agencies, and private banks to develop “sound financial alternatives” to increased private lending.

The Chairman also announced that the Federal Reserve System has undertaken an informal survey of bank practices “in defining, monitoring, and controlling risks in international lending” as part of its regular supervisory responsibilities. Each of these processes entails complex bank-management issues which are important to understand in appraising the soundness of individual banks and the banking system as a whole.

Defining exposure

The first problem a bank’s management confronts in country-risk appraisal is how to measure the bank’s exposure in an individual country. The actual definition of exposure is vital, because of difficulties involved in monitoring and controlling foreign lending when vague concepts are used.

Banks can compile figures on total credits outstanding and on commitments to individual countries, but adjustments invariably are required to measure credits at risk. This is where judgment comes into play. Credits covered by a third-party guarantee, for example, may be treated either as the obligation of the guarantor or of the borrower, depending on kind of guarantee.

Adjustments for individual credits may vary from bank to bank because of different philosophies towards risk-taking. Some banks may adopt guidelines designed to describe the “most likely” risk scenario, while others attempt to portray the “most adverse” situation. Hence, loans to multinational corporations may be treated as the obligation of the parent company (continued on page 2)
by some banks, and as the obliga­
tion of the subsidiary by others.

Similarly, fund placements with
branches or subsidiaries of foreign
banks in international financial cen­
ters (such as London, the Bahamas,
and the Cayman Islands) may be
considered as exposures in the
financial-center countries or as ex­
posures in the parent-bank coun­
tries. Moreover, funds placed at
banking offices in these financial
centers are typically re-lent to bor­
rowers located in other countries.
Obviously, this involves double­
counting; yet excluding the fund
placements might involve over­
looking the risk of possible ex­
change controls the financial cen­
ters could impose during a balance­
of-payments crisis.

Monitoring system
Once the measurement guidelines
are set, a procedure for monitoring
foreign-lending exposure can be
developed. A common bank prac­
tice is to set country limits (or coun­
try targets) and to review actual
lending experience periodically in
terms of the limits.

Bankers set country limits on the
basis of business considerations and
their appraisal of individual country
risks. In portfolio analysis, country
exposure typically is related to bank
capital or to bank assets. Economic
theory teaches the virtues of diver­
sification, but there are no hard or
fast rules to determine what ratios
constitute excessive exposure. A
bank’s judgment hinges on assess­
ment of its entire portfolio risk, as
well as on individual country risk.
The portfolio risk entailed in lend­
ing to oil-importing and oil­
exporting nations, for example,
may be less than the sum of the
individual risks, if an external
disturbance (an increase or de­
crease in the oil-price) has opposite
effects on the two groups. Hence,
what worries banks is not concen­
tration or risk per se, but rather
concentration in high-risk coun­
tries.

In individual country analysis, both
political and economic factors are
relevant. Foreign lending usually
involves sovereign risks (govern­
ment actions affecting public and
private debt) and transfer risks (as­
associated with conversion of foreign
exchange), in addition to normal
credit risks.

Political assessments usually touch
on two broad issues, political stabil­
ity and a country’s participation in
international lending organizations.
The former deals with the likeli­
hood of dramatic changes in the
government structure (or in gov­
ernment policies) which could af­
fect repayment prospects, while the
second issue is relevant for assess­
ing repayment prospects in the
event a country incurs balance-of­
payments problems or repudiates
its debt outright. The political re­
gime of a country may be highly
“stable,” for instance, but if it is not
an IMF or World Bank member, a
rescheduling would have to be ne­
gotiated in some other forum.

Economic assessments generally
cover a country’s growth prospects,
its near-term balance-of-payments outlook, and its external-debt profile. A common bank practice is to use a checklist of economic indicators supplemented by written commentary. The approach permits a broad range of variables to be considered, but judgments about the relative importance of each variable still have to be made in the overall assessment.

Econometric studies of past debt reschedulings indicate that external debt variables (the debt-service ratio and the average maturity of debt) are the factors most highly associated with debt reschedulings. These measures cannot easily be used for predictive purposes, however, because debt data are incomplete and usually two years out of date. Surprisingly, most studies have ignored macro-economic variables, despite the striking correlation between debt reschedulings and the inflation rates of those developing countries with sizeable external debt.

The adverse effect of severe inflation can be seen in the fact that 9 of 15 LDC’s with “high” long-term inflation rates (above 10 percent a year throughout 1960-75) rescheduled their debt during that period, while only 3 of 25 LDC’s with lower long-term inflation rates were forced into such action. Moreover, three of the high-inflation countries which did not reschedule pursued “gliding parity” exchange-rate policies geared to offsetting the adverse effects of inflation, while a number of rescheduling countries generally resisted exchange-rate changes. Thus, exchange-rate flexibility appears to be an important factor mitigating default prospects.

Control practices
The final stage bank managers undertake in country-risk appraisal involves periodic lending and country-limit reviews. Lending decisions require the bank’s overall marketing strategy (largely based on profit considerations) to be reconciled with lending risks. A major test of these control procedures occurs whenever a country which is a major borrower develops problems. Should the bank reduce the country limit in this case, or should it continue with its lending strategy? Again, judgments on country risk involve two types of errors—when a high-risk country is judged to be “credit-worthy,” and when a financially sound country is judged to be risky. While attention is often focused on the first problem, the second type of error is equally important to consider.

In sum, country-risk appraisal involves complex issues related to the measurement of country exposure, the setting of country limits and the periodic review of credits. Individual bank practices vary considerably in each phase, because of different attitudes towards risk taking and different conceptions of country risk. The ultimate test of a bank's ability to cope with these issues is its capacity to sustain a high rate of return in the competitive world of international banking.

Nicholas Sargen
## BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

<table>
<thead>
<tr>
<th>Selected Assets and Liabilities</th>
<th>3/02/77</th>
<th>Change from 2/23/77</th>
<th>Change from year ago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans (gross, adjusted) and investments*</td>
<td>92,649</td>
<td>+ 555</td>
<td>+ 6,046</td>
</tr>
<tr>
<td>Loans (gross, adjusted)—total</td>
<td>71,008</td>
<td>+ 652</td>
<td>+ 6,105</td>
</tr>
<tr>
<td>Security loans</td>
<td>1,517</td>
<td>- 29</td>
<td>+ 603</td>
</tr>
<tr>
<td>Commercial and industrial</td>
<td>23,253</td>
<td>+ 218</td>
<td>+ 260</td>
</tr>
<tr>
<td>Real estate</td>
<td>21,978</td>
<td>+ 45</td>
<td>+ 2,384</td>
</tr>
<tr>
<td>Consumer installment</td>
<td>12,465</td>
<td>+ 95</td>
<td>+ 1,686</td>
</tr>
<tr>
<td>U.S. Treasury securities</td>
<td>8,762</td>
<td>+ 15</td>
<td>- 251</td>
</tr>
<tr>
<td>Other securities</td>
<td>12,879</td>
<td>- 112</td>
<td>+ 192</td>
</tr>
<tr>
<td>Deposits (less cash items)—total*</td>
<td>92,014</td>
<td>+ 694</td>
<td>+ 5,315</td>
</tr>
<tr>
<td>Demand deposits (adjusted)</td>
<td>26,043</td>
<td>+ 719</td>
<td>+ 2,245</td>
</tr>
<tr>
<td>U.S. Government deposits</td>
<td>365</td>
<td>- 48</td>
<td>- 337</td>
</tr>
<tr>
<td>Time deposits—total*</td>
<td>64,109</td>
<td>+ 141</td>
<td>+ 3,380</td>
</tr>
<tr>
<td>States and political subdivisions</td>
<td>5,663</td>
<td>- 110</td>
<td>- 882</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>31,193</td>
<td>+ 130</td>
<td>+ 6,215</td>
</tr>
<tr>
<td>Other time deposits</td>
<td>25,316</td>
<td>+ 124</td>
<td>- 1,572</td>
</tr>
<tr>
<td>Large negotiable CD’s</td>
<td>8,765</td>
<td>+ 73</td>
<td>- 2,711</td>
</tr>
</tbody>
</table>

### Weekly Averages

<table>
<thead>
<tr>
<th>Member Bank Reserve Position</th>
<th>Week ended 3/02/77</th>
<th>Week ended 2/23/77</th>
<th>Comparable year-ago period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess Reserves (+)/Deficiency (-)</td>
<td>- 71</td>
<td>+ 61</td>
<td>+ 88</td>
</tr>
<tr>
<td>Borrowings</td>
<td>2</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Net free(+) / Net borrowed (-)</td>
<td>- 73</td>
<td>+ 59</td>
<td>+ 65</td>
</tr>
</tbody>
</table>

### Federal Funds—Seven Large Banks

<table>
<thead>
<tr>
<th>Interbank Federal fund transactions</th>
<th>Week ended 3/02/77</th>
<th>Week ended 2/23/77</th>
<th>Comparable year-ago period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net purchases (+)/Net sales (-)</td>
<td>+ 302</td>
<td>+ 716</td>
<td>+ 1,502</td>
</tr>
<tr>
<td>Transactions with U.S. security dealers</td>
<td>Net loans (+)/Net borrowings (-)</td>
<td>+ 68</td>
<td>+ 67</td>
</tr>
</tbody>
</table>

*Includes items not shown separately. $Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . . Information on this and other publications can be obtained by calling or writing the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 544-2184.