

Research Department
Federal Reserve
Bank of
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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

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by some banks, and as the obligation of the subsidiary by others.

Similarly, fund placements with branches or subsidiaries of foreign banks in international financial centers (such as London, the Bahamas, and the Cayman Islands) may be considered as exposures in the financial-center countries or as exposures in the parent-bank countries. Moreover, funds placed at banking offices in these financial centers are typically re-lent to borrowers located in other countries. Obviously, this involves double-counting, yet excluding the fund placements might involve overlooking the risk of possible exchange controls the financial centers 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 practice is to set country limits (or country 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 diversification, but there are no hard or fast rules to determine what ratios constitute excessive exposure. A bank's judgment hinges on assessment of its entire portfolio risk, as

well as on individual country risk. The portfolio risk entailed in lending 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 decrease in the oil-price) has opposite effects on the two groups. Hence, what worries banks is not concentration or risk *per se*, but rather concentration in high-risk countries.

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

Political assessments usually touch on two broad issues, political stability and a country's participation in international lending organizations. The former deals with the likelihood of dramatic changes in the government structure (or in government policies) which could affect repayment prospects, while the second issue is relevant for assessing repayment prospects in the event a country incurs balance-of-payments problems or repudiates its debt outright. The political regime 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 negotiated 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

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/02/77	Change from 2/23/77	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	92,649	+ 555	+ 6,046	+ 6.98
Loans (gross, adjusted)—total	71,008	+ 652	+ 6,105	+ 9.41
Security loans	1,517	- 29	+ 603	+ 65.97
Commercial and industrial	23,253	+ 218	+ 260	+ 1.13
Real estate	21,978	+ 45	+ 2,384	+ 12.17
Consumer instalment	12,465	+ 95	+ 1,686	+ 15.64
U.S. Treasury securities	8,762	+ 15	- 251	- 2.78
Other securities	12,879	- 112	+ 192	+ 1.51
Deposits (less cash items)—total*	92,014	+ 694	+ 5,315	+ 6.13
Demand deposits (adjusted)	26,043	+ 719	+ 2,245	+ 9.43
U.S. Government deposits	265	- 48	- 337	- 55.98
Time deposits—total*	64,109	+ 141	+ 3,380	+ 5.57
States and political subdivisions	5,663	- 110	- 882	- 13.48
Savings deposits	31,193	+ 130	+ 6,215	+ 24.88
Other time deposits‡	25,316	+ 124	- 1,572	- 5.85
Large negotiable CD's	8,765	+ 73	- 2,711	- 23.62
Weekly Averages of Daily Figures	Week ended 3/02/77	Week ended 2/23/77	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	- 71	+ 61	+ 88	
Borrowings	2	2	3	
Net free(+)/Net borrowed (-)	- 73	+ 59	+ 85	
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales (-)	+ 302	+ 716	+ 1,502	
Transactions with U.S. security dealers				
Net loans (+)/Net borrowings (-)	+ 68	+ 67	+ 148	

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

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