Overview

International Loans

Overview: Banks make international loans to cater to a wide variety of clients. International lending also allows banks to diversify their asset portfolios. In addition, banks often enter into syndications or participations to fund a large loan and spread credit risk. However, international lending creates additional risks to those inherent in domestic lending.

International credit: The structure of loans depends on the legal status of the borrower, which can range from offshore branches and subsidiaries to foreign governments. A global bank group with foreign offshore and foreign facilities and subsidiaries will also have options on where and how to book the loan depending on several factors including risk, legal/regulatory environments, capital requirements and hedging. Many international borrowers prefer to issue global securities because global debt securities are longer term than international loans and more likely fixed rate.

Credit analysis and loan underwriting: Procedures for loan underwriting should consider loan repayment terms and the borrower’s character, repayment capacity, capital stability, and collateral. Moreover, international loans introduce country risk, foreign exchange risk if the loan is extended in a foreign currency, and legal risk into the typical credit analysis. Since the Eurozone crisis, market participants are beginning to see that country and foreign exchange risks are pertinent to all countries not just to emerging market countries.

Loan syndications: Syndicates are formed when a creditworthy borrower requires a substantial amount of funding. The lender must procure a mandate to form the syndicate from the borrower, market the syndicate, specify the legal and operational issues of the loan, and monitor repayment.

International Lending Policies

Policy statement: The bank’s policy statement is meant to establish the scope of international lending to be undertaken by a banking unit. The policy statement should address, at a minimum, the following areas: risk tolerance limits, personnel handling the loans, portfolio mix of the bank, products offered, pricing, and minimum procedures to be observed.

Country Risk

Components: Country risk, which distinguishes international from domestic lending, comprises sovereign, political stability, rule of law, quality of bureaucracy, corruption, external/internal strife, expropriation and exchange controls. In conjunction with analyzing country risk, evaluating the economic risk in a country, both macro and fiscal elements, is very important in evaluating a loan to a foreign counterparty.

Supervision and regulation: Country risk supervision in the United States is carried out by the Interagency Country Exposure Review Committee (ICERC). The ICERC is responsible for providing an

assessment of the degree of transfer risk that is inherent in the cross-border and cross-currency exposures of U.S. banks. Although banks are advised of the results of the ICERC's evaluations, the ICERC's transfer risk ratings are primarily a supervisory tool and should not replace a bank's own country risk analysis process in ICERC. The primary purpose for ICERC is to establish reserves.

**Analysis of Country Risk:** Country Risk should not only focus on the borrowers or counterparties but also should consider country risk of the bank’s foreign operations or facilities.
Introduction

Importers/exporters, global corporations, foreign local business and consumers, foreign banks and overseas branches of U.S. banks, and foreign governments all borrow funds from banks. Historically, only the largest global banks lent money internationally. Select banks, such as J.P. Morgan Chase, Bank of America, and Citigroup, compete with other global banks, such as Deutsche Bank, NatWest Group (formerly Royal Bank of Scotland), and Barclays Capital, in the international loan syndication market.

International loans tend to be much larger than domestic credits. Large loans benefit from economies of scale, which allow banks to originate, monitor, and collect loans on a proportionally less costly basis than smaller advances. The reduced cost involved in making large loans is usually reflected in their interest spread (interest income on loans less cost of funds), which is often much lower than on smaller transactions. Bankers that are not active in the international market, however, may not benefit from the reduced costs associated with these larger loans as other costs, such as functional operating costs, credit risk, transfer risk, or the required capital needed to support the international investment may outweigh the advantages of the larger loans. U.S. banks remain among the most active originators of loan packages worldwide. There is also a secondary market for syndicated loans.

This Lesson is structured in three sections. The first section distinguishes the types of loans originated in the international market. International lending extends the analysis of a loan from the domestic framework normally established by the “Five Cs of Credit.” Character, capacity, capital, collateral, and conditions all apply to international loans. Foreign lending also exposes a bank to country risk, a sixth “C of Credit.” Consequently, examiners need to be concerned with the economic, transfer, and country risks of a host country, as well as with the underlying strength or weakness of an individual debtor and any collateral. As a result of completing the initial section, examiners will be able to differentiate between the risks of international and domestic lending.

The second section reviews the international lending policies and procedures a bank should implement to ensure the activity is compatible with safe and sound operations. A written policy must establish the scope of international lending and address personnel responsibilities, acceptable products, applicable pricing methodologies, and required underwriting procedures. International lending affects the overall strategic plan and financial management of a bank. The amount and mix of international loans can impact the liquidity risk, sensitivity to interest rate and currency risks, credit risk, and regulatory capital requirements of a bank. As a result of completing the second section, examiners will be able to identify the policies that should be approved and implemented by a bank active in international lending.

The final section covers country risk. Country risk is sometimes confused with foreign exchange risk, yet the two are distinct. Lesson 5 reviews foreign exchange risk. Country risk has usually been thought to be unique to international lending. Since the 2008 financial crisis, analysts and bankers are increasingly thinking of country risk as a risk that needs to be identified and monitored for any foreign exposure not just lending to foreign governments. Country risk is comprised of factors such as sovereign risk, political stability, expropriation, exchange controls, quality of bureaucracy, laws and enforcement, currency

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2 Foreign exchange risk reflects the fluctuation in the earnings stream or asset valuation that results from a shift in the relative value of two currencies.
transfer restrictions, internal or external conflicts, and corruption. International lending also exposes banks to additional reputational and operational risks. These problems may lead to default, a payment moratorium, lack of access to collateral, or a forced rescheduling, consequently reducing the value of a loan. The regulatory classification framework and reserve for loan losses differs for international loans to reflect these additional risks. The Interagency Country Exposure Review Committee (ICERC)\(^3\) administers a special program for U.S. banks to differentiate the debt capacity and transfer risk of loans in or to other countries. As a result of completing this Lesson, examiners will be able to define and evaluate the concept of country risk and will be able to apply the country risk classifications established by ICERC.

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\(^3\) ICERC is undergoing policy review.
International Loans

Overview
International lending allows banks to establish a source of additional demand for credit and to diversify their asset portfolios beyond their home country. For example, rather than sell federal funds to another U.S. depository institution, a bank can place funds with a foreign bank or an overseas branch of a U.S. bank. Rather than purchasing U.S. Treasury bills, notes or bonds, a bank can make a loan to, or acquire obligations of a foreign country. Rather than originating a commercial loan for a domestic company, a bank can purchase a loan from a syndicate for or acquire a participation interest in a loan to a global corporation. International lending increases the number of potential borrowers for a bank and allows bankers to better serve the financial needs of existing international clients.

Many U.S. and foreign banks—especially Japanese, German, Swiss, French, and British—enter into syndications to originate and place international loans. The syndication allocates fees to participating banks based on the contribution of the bank to arranging, packaging, selling, and funding the loan. Fees provide one source of revenue from international lending. Most international loans are priced off a reference rate known as the interbank offer rate. The most common interbank rates are LIBOR (London Interbank Offer Rate) and EURIBOR (Euro Interbank Offer Rate). LIBOR represents the interest rate on U.S. dollar time deposits traded outside the United States. EURIBOR represents a similar rate for instruments denominated in the euro. Given that a number of banks have been accused of manipulating LIBOR rates during the 2008 financial crisis, market participants and regulators are looking for alternatives or more oversight to LIBOR. In April 2013, the Financial Stability Oversight Council (FSOC) recommended to the U.S. Congress that alternative benchmarks to LIBOR be explored. The primary Libor reform to date has been to discontinue the British Bankers Association’s control over the LIBOR setting process and shift its administration to the Intercontinental Exchange (ICE). ICE is ultimately required to anchor its LIBOR calculations in more concrete transactions data, which would be more difficult to manipulate Lesson 6 more fully describes the economic and regulatory factors affecting LIBOR and EURIBOR. Riskier loans carry a higher spread off the reference rate. International loans are also priced off FIBOR (Frankfurt), MIBOR (Milan), or TIBOR (Tokyo), among other regional interbank rates of interest.

Each bank must determine whether the fees and interest income from foreign lending are commensurate with the risks. Since the late 1980s, under The Basel Accord, domestic and foreign loans have been assigned risk weights that vary between 0 and 100 percent for risk-based capital purposes. Some foreign loans to member countries (e.g., U.K. and Japan) of the Organization for Economic Cooperation and Development (OECD) have been classified as a zero percent risk-weighted asset. Under Basel II and III, the standardized approach assigns a zero percent risk weight to sovereign issuers with an AAA/Aaa or AA/Aa credit rating. Under section 939A4 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, banks in the U.S. cannot use ratings for regulatory capital purposes. Countries with lower credit ratings will be assigned higher risk weights for capital purposes. By contrast, the risk weight of international loans established by Basel II and III’s advanced internal ratings approach will be based on the probability of default, the loss given default, the exposure at default, and the correlation of the asset

with an index of returns. Less risky loans will be assigned low risk weights while more risky loans will carry higher risk weights (e.g., more than 100 percent). As Basel III is being implemented globally, how large, internationally active banks calculate Risk Weighted Assets (RWAs) is being increasingly scrutinized.

Asset quality for foreign loans is often more difficult to measure than for domestic credits. Standard ratios that reflect a debtor’s capacity and capital are based on a different chart of accounts and accounting principles than are common to the United States. Legal standards differ from country to country. For example, a bank may be unable to perfect an interest in certain types of collateral, such as real estate or a controlling equity interest in a company based in other countries. As a result of legal and jurisdictional problems, banks find that collateral and conditions applicable to structuring a loan internationally differ from a domestic alternative. Some countries’ legal systems, such as the United States, favor the rights of debtors when facing distress; other systems, such as the U.K.’s or Germany’s, favor the rights of creditors. When the fees and interest income available from international lending are commensurate with the cost and applicable risks, the market attracts more banking institutions.

Increasingly, many large global banking companies have determined it is more profitable to underwrite debt, rather than commit to a long-term loan. A bank underwrites debt by purchasing a security from a firm and quickly reselling the bond to other institutional investors. Similarly, many large borrowers have found they can more cheaply, easily, and quickly obtain a large amount of long-term funds by issuing global bonds. Capital market activity has replaced a significant amount of international lending during the past several decades.

The remainder of this section will focus on the differences between international and domestic lending. By successfully completing this section, examiners will be able to answer the following questions:

- What types of international loans do banks make and to which debtors?
- What is the structure of international loans?
- How does the credit analysis of an international loan differ from that of a domestic loan?
- What is a loan syndication? How may a bank enter into a syndication? What risks are encountered?

**International Credit**

International lending is a specialized activity. While international lending has far more similarities than differences with domestic lending, international lending can have more country risk for lenders and can expose lenders to foreign currency risk. U.S. financial institutions’ foreign lending is geographically dispersed., with the majority of U.S. activity concentrated in loans to entities from developed countries, with the largest exposures to the UK, and to a much lesser extent Japan, and Germany in that order. When many countries, including Turkey, Venezuela, Chile, Poland, the Philippines and Mexico, defaulted on loans to global banks in the early 1980s, global banks retreated from aggressively courting international business. Defaults by Russia in 1998 and Argentina in 2002 and the European sovereign-debt crisis remind the market that country risk can be a recurring source of loss.
International lending has changed significantly since the 2008 banking crisis\(^5\). According to the IMF in 2015, "First, direct cross-border lending as a share of total banking assets has declined, mostly because of the retrenchment of European banks. Second, the share of local lending by foreign bank affiliates has remained steady. Global banks in particular have refocused their activities on some key markets, leaving space for other banks to expand. As a result, intraregional financial linkages have deepened, especially in Asia. Although the cutback in cross-border lending was triggered by the financial crisis, regulatory changes and weaknesses in bank balance sheets have contributed significantly to the subsequent retrenchment. Better-capitalized banks were more likely to maintain cross-border lending. Macroeconomic factors have also played a role\(^6\)."

As of the end of June 30, 2021, US banks' total exposure was about $21.6 trillion\(^7\), a rise of 9% from the same period in 2020. 77% of US banks' exposures are to US counterparties; this figure is slightly lower than last year when it represented about 78%. The remaining 23% of the exposures are to counterparties in foreign countries, international banking centers, and regional and international development banks. According to Country Exposure Report (009) data published in the E16 Lending Survey, as of the end of June 2021, foreign exposures for U.S. banks reached $4.9 trillion, 11% higher than in 2020. While the total average US bank exposure to foreign counterparties is low, amongst the largest U.S. banks, foreign exposure is much higher. About 40% of Citibank’s revenues come from credit and market exposures to emerging markets.\(^8\)

### Exhibit 3.1 – U.S. Banks’ Exposures

<table>
<thead>
<tr>
<th>Claims - Ultimate-Risk Basis /2</th>
<th>Claims on Local Residents (Excluding Claims from the Fair Value of Derivative Products)</th>
<th>Cross-border Claims (Excluding Claims from the Fair Value of Derivative Products)</th>
<th>In Non-Local Currency</th>
<th>In Local Currency</th>
<th>Claims Resulting From the Fair Value of Derivative Products /3</th>
<th>Country Risk Claims /4</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(A)</td>
<td>(B)</td>
<td>(B1) = (B - B1)</td>
<td>(C) = (A+B+C)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>G-10 and Luxembourg</td>
<td>1,118,188</td>
<td>1,291,759</td>
<td>162,960</td>
<td>1,128,799</td>
<td>161,679</td>
<td>2,571,626</td>
</tr>
<tr>
<td>Non G-10 Developed Countries</td>
<td>271,557</td>
<td>145,845</td>
<td>5,351</td>
<td>140,494</td>
<td>30,094</td>
<td>447,496</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td>28,263</td>
<td>31,582</td>
<td>4,010</td>
<td>27,572</td>
<td>2,249</td>
<td>62,094</td>
</tr>
<tr>
<td>Latin America and Caribbean</td>
<td>150,281</td>
<td>142,051</td>
<td>12,644</td>
<td>129,407</td>
<td>9,171</td>
<td>301,503</td>
</tr>
<tr>
<td>Asia and Pacific</td>
<td>334,566</td>
<td>224,928</td>
<td>25,645</td>
<td>199,283</td>
<td>11,257</td>
<td>570,751</td>
</tr>
</tbody>
</table>

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\(^6\) “Increasingly Local and Safer?” IMF, 2015.


\(^8\) [https://realmoney.thestreet.com/articles/01/11/2016/citigroup-tops-list-u.s.-banks-exposure-china](https://realmoney.thestreet.com/articles/01/11/2016/citigroup-tops-list-u.s.-banks-exposure-china)
Almost 80 percent of the $4.9 trillion of banks’ foreign exposures are to developed countries, international banking centers and to international organizations. The top three countries to which U.S. banks are exposed are the UK ($679 bn), Japan ($479 bn), and Germany ($405 bn). U.S. banks exposures to the UK have declined from 2019 and have increased to a number of other European countries and to Japan, largely due to the uncertainty surrounding Brexit.

Exposures to emerging market countries account for 20 percent of total U.S. bank foreign exposures. The top emerging markets for U.S. banks in order of exposure volume are China ($146 bn), South Korean ($123 bn), Mexico ($114 bn), and Brazil ($92 bn). While US banks' credit exposure to China is small on a relative basis, it is important to note that exposure has grown over 460% from $26 billion at the end of 2007 to $146 billion at the end of June 2021. Citibank and JP Morgan have the highest exposure to China9. Since 2006, U.S. banks have reduced their exposures to Europe to diversify more toward exposures to Asia and Latin America.

The global banking system has reduced its portfolio commitment to international lending for a variety of reasons:

**Interest Spread:** International loans are often priced with a small spread above LIBOR or EURIBOR. State-owned banks in other countries need not generate a return on equity commensurate with expectations of private investors and are able to price loans with low spreads off the applicable interest rate index. Banks can only afford a low spread if the activity generates a sufficient volume of fees or other fee-based business. Most banks earn a narrow but positive spread between the yield on international loans and the cost of foreign deposits. Examiners should focus on credit, interest rate, and sensitivity to market risks when the international spread exceeds that for domestic activity.

**Asset Quality:** Banks worldwide struggled to manage asset quality between the 1970s and 1990s. Problem domestic real estate loans and loans to developing countries contributed to large write-offs. Consequently, many global banking units gravitated to less risky assets, including domestic governmental and agency securities. Other banking units elected to pursue domestic subprime consumer and mortgage loans that carried high rates of interest yield and lower prepayment risk despite a higher default risk without introducing country or currency risks. Yet, that strategy was a major cause of the 2008 financial crisis.

Asset quality plagued European banks since the 2008 banking crisis and the Eurozone crisis until 2017. At the end of 2015, the European Banking Authority published an extensive bank analysis of 70 percent

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9 https://realmoney.thestreet.com/articles/01/11/2016/citigroup-tops-list-u.s.-banks-exposure-china
of all European banking assets. It found that while banks’ capital levels are improving, significant concerns with non-performing loans remained. In mid-January 2016, the European Central Bank highlighted asset quality concerns at Italian banks.

In March 2016, the European Banking Authority's (EBA) annual transparency exercise showed large gaps in asset quality across European banks. In particular, asset quality in Austria was considerably weaker than in Germany, and Spanish banks had sizable legacy assets versus their European peers. "The EBA data show that weak loan performance is a major challenge for Austrian banks while credit quality in Germany is more benign, supporting those banks' profitability," stated Swen Metzler, a Vice President at Moody's Ratings Agency. "Non-performing exposures in Austria amounted to €24 billion at end-June 2015, or 8.0% of Austrian banks' total credit exposure, while for German banks, NPEs amounted to €76 billion, or 3.4% of total lending."

On July 4, 2017, The European Banking Authority (EBA) announced that in the first quarter of 2017, “EU banks' common equity tier 1 (CET1) ratio remained high, albeit a modest decrease of 10 basis points (bps) to 14.1% was observed. This effect was mainly driven by an increase in risk-weighted assets, which is partially offset by an increase of capital ("other reserves").” The EBA also stated that the ratio of non-performing loans (NPLs) maintained a modest downward trend, decreasing by 30bps to 4.8%, and suggesting that supervisory efforts are bearing fruit, albeit slowly. Looking forward, the Risk Assessment Questionnaire shows that more than 50% of the banks expect a stable level of impairment provisions in the next 12 to 18 months, while almost 30% expect impairment provisions to decrease. Banks and market analysts also expect increases in the quality and volumes of lending, to small and medium-sized enterprises and residential mortgages.

On December 11, 2020, the European Banking Authority announced that banks in Europe had solid capital and liquidity positions. Yet, it warned about asset quality prospects and structurally low profitability. The EBA found that in comparison to the global financial crisis, bank lending to the real economy increased. In the early stages of the COVID-19 outbreak, non-financial corporations (NFCs), especially small and medium-sized enterprises (SMEs), made use of available loan commitments to secure liquidity and operational continuity. According to the EBA “Despite the stability of the non-performing loan (NPL) ratios, other metrics show early indications of deterioration in asset quality. The volume of NPLs slightly increased in the second quarter, but the NPL ratio continued its contracting trend (50 basis points [bps] down YoY) due to raising loan volumes.”

The EBA also found that “Banks have significant exposures that are vulnerable to climate risk. According to a preliminary analysis of recently collected data, more than 50% of exposures to large corporates are to sectors potentially subject to transition risk. In particular, the largest share of climate-relevant exposures comprises exposures to manufacturing, electricity, construction, transport and real estate sectors.” The full report may be found here.

**Strategy:** Some financial holding companies have elected to focus on competing with investment banks and formed subsidiaries to underwrite, trade, and sell debt rather than making portfolio commitments.

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Other banks believe that high interest rates, growth opportunities and intermediate term of consumer loans are more desirable for a portfolio than international loans.

Market Innovation: Many foreign borrowers have turned from intermediate-term, floating-rate international loans to long-term, fixed-rate global bonds to raise capital. Foreign countries and global banks are able to raise large amounts of funds, often exceeding $5 billion, at attractive rates of interest. International Financial Markets are discussed in more detail in Lesson 6.

Managing Risk: Institutions use derivatives to manage the additional risks found in international credits. Derivatives are discussed in more detail in Lesson 7.

Banks’ claims on and liabilities to non-bank financial institutions (NBFIs) have been growing in recent years. Foreign currency credit to non-bank borrowers, especially in dollars has been rising in the last few years. A low interest rate environment was favorable to non-bank borrowers. According to the Bank for International Settlements September 2020 BIS Quarterly Review “Cross-border links between banks and non-bank financial institutions (NBFIs) gained momentum in recent years. Banks’ cross-border claims on NBFIs rose from $4.6 trillion in Q1 2015 to $7.5 trillion in Q1 2020, a faster increase than that of total cross-border claims. Financial centers and large advanced economies play a prominent role, as hosts of the largest and most interconnected NBFIs such as central counterparties, hedge funds and investment funds. The size of banks’ cross-border links to NBFIs in emerging market economies has also been on the rise, albeit from a low base. The financial market turmoil triggered by Covid-19 revealed several vulnerabilities associated with cross-border linkages between banks and NBFIs.” The BIS highlighted that,

- Cross-border bank claims on non-bank financial institutions (NBFIs), such as investment funds and central counterparties, have grown 63% in the last five years to $7.5 trillion in Q1 2020.
- Financial links between banks and NBFIs are mainly denominated in US dollars and concentrated in financial centers and large advanced economies but have also grown in emerging market economies.
- Vulnerabilities stemming from these growing interconnections were highlighted during the Covid-19 market turmoil, for example in fickle dollar funding from NBFIs and liquidity pressures from high central counterparty margins.

Banks’ cross-border claims on, and liabilities to, NBFIs grew strongly in recent years. The outstanding number of cross-border claims increased from $4.6 trillion in the first quarter of 2015 to $7.5 trillion in the first quarter of 2020, a notable rise of six percentage points when scaled by total cross-border claims.
According to BIS economists, Iñaki Aldasoro, Wenqian Huang and Esti Kemp, “Non-bank financial intermediation provides additional sources of financing for households and corporates. But it can also contribute to systemic risks through links with the banking system. In the wake of the Great Financial Crisis, G20 leaders requested that the Financial Stability Board (FSB) develop recommendations to strengthen the oversight and regulation of “shadow banking.”
Exhibit 3.3 - NBFI’s global assets grew strongly over the past decade

Sources: FSB, Global monitoring report on non-bank financial intermediation 2019; BIS locational banking statistics (by residence); authors’ calculations.

**International Loans:** Bank examiners should expect to see international loans in global banks. International lending allows banks to diversify their credit portfolio from their home country and enter geographic markets expanding more quickly than in a developed country.

Examiners may encounter international loans when examining a U.S. bank, a subsidiary of a U.S. bank, a foreign branch, or an agency of a foreign bank. These loans may be differentiated by the legal status of the borrower:

**Offshore Branches, Subsidiaries, and Affiliates:** Depending on loan demand, interest rates, liquidity, and other factors, a bank may redistribute its funds to branches, subsidiaries, or affiliates of its main office. For example, a money-center bank located in New York City may fund its own branch in Zurich. The Swiss branch may elect to convert U.S. dollars to Swiss francs to lend the funds to local customers. The branch will be paid interest and repaid principal in Swiss francs. The transaction creates foreign exchange risk because the overseas branch received funds denominated in dollars and lent funds denominated in francs. The risk created by a currency mismatch must be identified, measured, monitored, controlled, and limited to amounts that promote safe and sound operations. The branch will be adversely affected if the currency of the loan depreciates, or the currency of the liability appreciates. Alternately, the Swiss branch may elect to place the dollar funds received in a U.S. dollar-denominated asset.

Transfer risk, also often referred to as exchange controls, is another concern. Transfer risk occurs when a foreign government prohibits or limits conversion of the local currency into the bank’s home or other currency. For example, Argentina requires permission to convert Argentinian pesos into U.S. dollars.
**Foreign Branch of Other Banks:** A bank may lend funds through the interbank market by purchasing a certificate of deposit (CD) from a branch of a foreign bank. The purchaser or investor faces several risks from the placement. First, there is the normal credit risk applicable to the bank. How safe and sound is the institution? Second, there is country risk. The government may impose capital export controls or expropriate the assets of private companies. What are the economic, and transfer risks of the country? Third, there may be currency risk if the CD is denominated in a currency other than U.S. dollars. Is the currency invested projected to appreciate or depreciate? The majority of Euromarket transactions are denominated in either U.S. dollars or euros. Finally, the transaction creates reputational risk if the foreign bank is laundering money or found guilty of other illegal activities.

**Foreign Central Governments:** Banks have made loans to foreign central governments for hundreds of years. Some of these loans have been rescheduled because of the financial problems of the country. These problems still exist and will continue to occur with countries experiencing political, fiscal, and monetary or currency problems. A secondary market for these loans exists. The prices of select developing country debt are quoted at a fraction of par. For example, a U.S. dollar-denominated loan to Argentina was quoted at a price of 20 (100 par) when the government defaulted on its international obligations in 2002. The loan had been trading at a price of 90 one year earlier; a $100 million par position would have lost $70 million in one year. The secondary market price reflects both changes in interest rates related to the currency of the loan and country risk. ICERC and the international credit rating agencies evaluate credit extended to foreign countries.

**Global Corporations and other Foreign Borrowers:** Banks also lend to companies, their subsidiaries, and wealthy individuals (international private banking). As with domestic credits, a bank must know its customer, identify the purpose of the loan, and monitor several sources of repayment until fully repaid.

The typical international loan is structured with a floating rate for a term between one and five years. By contrast, international and global bonds are often structured with a fixed rate for terms of ten or fifteen years.

About 60 percent of international loans flow to borrowers in developed countries. The key countries include Germany, the United Kingdom, Switzerland, Japan, and the United States. With the exception of Japan, each of the countries is rated in the range of AA – AAA by the international rating agencies, Fitch Ratings, Moody’s and Standard and Poor’s.

The major emerging markets as defined by the Bank for International Settlements (BIS) include China, India, Mexico, Brazil, Argentina, Poland, Russia, and the Czech Republic. In the mid-2000s, continuing defaults by countries led banks to cut their exposure to emerging market debtors. During the financial crisis of 2008 U.S. and European banks decreased their lending to emerging markets primarily due to the weaknesses of the banks and due to their need to comply with increased capital requirements. Starting in 2012, banks again increased their appetite for higher yield and increased their lending to emerging market corporates and financial institutions. According to the 009 report, about 24 percent of US bank loans are to emerging market countries. About 19 percent of international funds are directed to debtors in offshore locations, such as Hong Kong or the Cayman Islands and to international multilateral entities. The country risk of some of these debtors could be reallocated to their country of origin. In 2021, debt in emerging markets hit a fresh record high of $92.5 trillion.
About 19 percent of international funds are directed to debtors in offshore locations, such as Hong Kong or the Cayman Islands and to international multilateral entities. The country risk of some of these debtors could be reallocated to their country of origin.

Countries do default. Sovereign defaults and even downgrades can adversely impact banks and companies. Exhibit 3.5 illustrates the geographic distribution of the regions within the world where global banks lend money to emerging countries. Key regions include Latin America (e.g., Mexico or Brazil), Asia and the Pacific (e.g., China, India, Malaysia or the Philippines), parts of Central and Eastern Europe (e.g., Russia or Poland), and Africa (e.g., Egypt or Angola). When problems arise in any country, it is not uncommon to have these loans placed in a moratorium, rescheduled, or repudiated.

According to a long-term sovereign debt default study released by Moody’s Investors Service in April 2015 a defaulted sovereign bond on average is worth about 29 percent of its original value. That is, a bond that was originally worth par ($100) would be valued at $29 after defaulting. 2022 is the 40th anniversary of the last Mexican default. On August 12th 1982, Mexico’s finance minister Jesús Silva Herzog stated that the government would run out of money in four days,” After Mexico’s default, 26 other developing countries (including 15 in Latin America) eventually had to reschedule their debts.

**Exhibit 3.4 Loans to Emerging Market Economies**

Source: BIS Quarterly, September 2020.

In the immediate years before the COVID-19 crisis, countries such as Turkey, Korea, Mexico, and Saudi Arabia have seen significant increases in the indebtedness of their non-financial corporations, especially in the current low interest rate environment.

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12 Further information on the BIS locational banking statistics is available at [www.bis.org/statistics/bankstats.htm](http://www.bis.org/statistics/bankstats.htm).
An important topic in 2022 for banks with emerging market exposure will be the impact of potential interest rate rises on the health of emerging market economies and their financial system. According to Federal Reserve researchers “Rising U.S. interest rates are often thought to be bad news for emerging market economies (EMEs) as they increase debt burdens, trigger capital outflows, and generally cause a tightening of financial conditions that can lead to financial crises.” The report, “Are Rising U.S. Interest Rates Destabilizing for Emerging Market Economies?” may be found here.\(^\text{13}\)

Credit Analysis and Loan Underwriting

Loan underwriting normally covers the following four important segments: loan purpose, repayment sources, structure, and monitoring. Underwriting procedures should address, at a minimum, the following questions.

- Who is the borrower?
- What is the purpose of the loan?
- What factor(s) precipitated the need to borrow?
- How long will the loan be outstanding?
- How stable is the bank, the business and/or the country?
- How qualified is management and/or the government administration?
- What is the financial or economic condition of the debtor?
- What is the anticipated source of cash flow from the borrower?
- Are there two or more sources of repayment?
- How liquid are the assets that the borrower has? And what is the credit quality of those assets?
- What conditions should be included in the loan agreement?
- Are there any types of marketable collateral available?
- Can the collateral be attached and perfected? In addition, can the collateral be located and sold?

These questions relate to the character, capacity, and capital of a borrower, and the collateral and conditions specified by a loan agreement and/or note. Although there are differences, international loans may be evaluated using principles applicable to domestic lending. By completing this section, examiners will be able to compare and contrast similarities and differences applicable to underwriting international versus domestic loans. In addition, credit factors differ between a loan to a sovereign borrower versus credit to a global company or an individual located in another country.

Character

One of the most important aspects of any loan is the character of the borrower. This may be evaluated by reviewing the borrower’s credit history, repayment habits, communications with the bank, and overall industry reputation. Some emerging markets can be particularly opaque; they may not have credit bureaus, or credit histories may not be publicly available. What is the quality, depth, and expertise of management? Does the firm have any judgments or other legal problems outstanding? Who is in charge of the company’s daily operations? What is the ultimate purpose and destination of the loan? Character represents the willingness of a borrower to repay obligations when due. It is important to note that many countries do not allow banks or other firms to maintain or share information regarding past and existing credit histories. Consequently, it is often more difficult to obtain information necessary to gauge character. By contrast, there is a large amount of public information related to the credit history of sovereign borrowers. The major credit rating agencies continue to assign low ratings to the debt of many emerging market countries that have previously defaulted on their international loans. Although these countries may have since changed governmental systems and instituted economic change, their default history still adversely affects their current credit ratings. Bank examiners can also look at credit spreads of
emerging market borrowers by looking at the bond yield or the spread on the single name credit default swap relevant to the issuer.

Low debt ratings, however, can also be assigned to more developed countries such as during the European sovereign-debt crisis.

The bank must know who the borrower is. This seems obvious, but it is often difficult to determine if the firm is a global company (i.e., state-owned enterprise) owned by the government. Has the parent or the foreign government guaranteed the loan? Are there related companies that are not consolidated in the borrower’s financial statements but for which actual liability may exist? Foreign individuals may use banking relationships to mask illegal activities. A person can often hide information more easily than a corporation can.

**Capacity**

The capacity of a borrower represents the ability to repay a loan on a timely basis. Short-term loans are generally repaid by the conversion of current assets to cash, while long-term loans are repaid by cash flow from operations. Capacity is often measured by financial ratios that reflect the borrower’s liquidity (current ratio, quick ratio, or cash ratio), profitability (gross profit margin or net profit margin) and solvency (debt ratio, times interest earned, or operating cash flow to term debt). The financial analysis must not only recognize the condition of the debtor prior to receiving the loan but also project the benefit of generating cash flow that results from investing the loan proceeds. Capacity is predominantly measured through financial ratios derived from historical and pro forma financial statements. The capacity of a country may be measured by the size and trends of the fiscal and trade deficits and the amount and maturity of international debt compared to exports and foreign reserves.

Financial statements prepared by foreign borrowers may not be timely or comparable with U.S. accounting principles. Many foreign companies prepare financial statements semi-annually or annually and do not distribute the information until first presenting it to their board of directors at an official meeting. As a result, banks may be unable to obtain full financial disclosure on a timely basis. The statements often do not correspond to generally accepted accounting principles common in the United States. Historical cost accounting principles are not embraced globally. For example, fixed assets may be revalued annually by an inflation index compiled by the government. The fixed asset appreciation may be recognized in the capital account. Companies may also use hidden reserves to mask foreign currency gains or losses. As a result, examiners must attempt to focus on cash flow from operations, investments, and financing activities, rather than relying on accounting accruals and revaluations.

**Capital**

Capacity and capital are closely related concepts. Capacity represents the stability and amount of cash flow the debtor expects to generate to service a loan. Capacity is derived by converting current assets to cash or from operating cash flow. Capacity is dynamic, while capital is a static measure. Can the firm raise cash by selling assets or by issuing securities? Capital is often measured by the net worth or equity base of a borrower. Capital measures suffer from all the data problems applicable to capacity. Capital of a country can be approximated by the reserves of hard currency (e.g., U.S. dollars, euros, pound sterling, and yen), gold and short-term securities of developed countries. The reserves on hand must be compared to the sum of annual imports and debt obligations that require payment in a foreign currency. Credit risk of wealthy consumers is based on their confirmed net worth and income. Credit risk of other consumers is
often managed by charging very high rates of interest (e.g., 40 percent per year or higher) to individuals without a credit history and/or job. High interest rates are applied to mitigate credit risk.

The debt-to-capital varies significantly in different countries. These differences exist between industrialized countries and within emerging markets. The United States is closer to Britain than Japan. The different capital ratios reflect variations in taxation, ownership, culture, and risk tolerance. Companies located in countries with higher income tax rates are more likely to rely on debt given the more favorable tax shield created by interest expense. Emerging market companies exhibit striking differences in capital structure. The long-term debt-to-assets of manufacturing companies can range from almost 40 percent in countries such as India to virtually none in Indonesia. The global differences reflect the existence of a viable long-term capital market and the relative cost of long-term debt.

The net worth of a firm or a high net-worth individual represents their assets less liabilities. If the assets are overvalued, such as by revaluing fixed assets by an unsupported index, or the liabilities are understated, such as by omitting currency translation of debt, net worth will be misstated for purposes of U.S. comparability. Net worth itself does not provide cash to repay a loan. Assets must be sold, or new financing arranged if net worth is to provide a source of loan repayment.

**Conditions**

A loan requires a note or an agreement to define repayment terms. The agreement will typically contain basic information including the names and addresses of the borrower, guarantor, lenders, and agents; the amount, interest rate, currency and maturity of the loan; repayment and drawdown details; warranties; and events of default. The loan agreement will also cover the jurisdiction of legal disputes, cross-default, negative pledge, Eurodollar availability, judgment, currency, sovereign immunity, indemnification from reserve requirements, and increased costs clauses.

While international loans are similar to domestic loans regarding conditions, several factors are sufficiently different to deserve emphasis. First, the currency of the loan proceeds, interest payment, and principal repayment must be clearly articulated. Second, the interest rate will normally use LIBOR, EURIBOR, or some other interbank rate, rather than prime, as a reference rate. LIBOR and EURIBOR are market rates while prime is an administered rate. Third, the jurisdiction of disputes must be identified (e.g., London or New York). Fourth, when the borrower is a government, the issue of sovereign immunity arises. A government is privileged and as a general rule cannot be sued. A loan agreement may waive this immunity; this is an important clause to be included in a loan to a government. Fifth, many loan agreements provide lenders an escape clause if the Eurodollar or euro interbank markets are under strain. If there is no LIBOR or EURIBOR quoted, the lending banks and the borrower must negotiate a new, mutually acceptable loan within 30 days. If an agreement is not forthcoming, the availability clause requires the loan to be repaid. Sixth, some companies, especially German and Japanese, rarely issue guarantees. A loan agreement may specify “comfort letters” or debt maintenance agreements. Comfort letters, however, are not guarantees and may not prove enforceable. Banks are strongly encouraged to have local legal counsel assist in preparing documents and loan agreements. Conditions of international loans, like domestic loans, are subject to negotiation between the lender and the borrower.
**Collateral**

The existence of collateral may reduce the consequence of default risk on a foreign loan. Two major questions arise regarding collateral. First, can a bank attach and perfect a lien on the debtor’s assets? Second, if the collateral is seized, can the bank convert the asset to cash, and if so, can the cash be repatriated? Legal constraints vary by country. Bankers can obtain a lien relatively easily in Australia, while it is very difficult in Italy. Other countries, such as Poland, provide senior liens to selected entities that are not reflected in public records. Because much of U.S. law is based on British common law, U.K. and U.S. standards are relatively similar. U.K. law, however, favors creditors while U.S. law favors debtors. Some countries do not allow foreign investors to own real estate or a controlling interest in the common stock of a national company.

Foreign collateral, especially real assets like equipment and inventory may be difficult to value. The assets may or may not reflect appropriate foreign currency translations. In other cases, firms who have defaulted on a loan may not voluntarily turn over collateral to their banks. Though foreign collateral, like domestic collateral, is not a preferred source of repayment, it is a potential source of loan repayment. Availability of courts or legal structure may make the collection or liquidation of collateral difficult or lengthy.

There are two principal methods used by banks to extend international credit. The first method involves the financing of international trade, which is covered in Lesson 4. Some governments establish programs that facilitate trade. The Export-Import (EXIM) Bank in the United States provides working capital loans for U.S. exporters and term loans for importers of U.S. goods to reduce country risk and normal debtor risk. The second method involves extensions of credit covering a wide variety of purposes. These are similar to those of a domestic loan portfolio and include leasing, short-term working capital, project financing, or real estate. Global banks typically originate an international loan to corporations, banks, and governments via syndication.

**Loan Syndication**

By forming a syndicate, banks collectively can offer creditworthy customers a larger amount of funds than they could individually. A syndication is the central structure banks use to offer credit to entities with significant global funding requirements. U.S. banks often lead the world in structuring and managing syndications. A syndicator must have various capabilities:

1. the ability to market loan participations to other financial institutions,
2. the capability to perform credit and country risk analysis and to price the facility correctly, and
3. a dispersed geographical structure to identify market opportunities quickly.

A syndicate allows the banking system to market financial services efficiently and meet the credit requirements of debtors with large loan requirements. More important, the syndicate facilitates portfolio diversification. A bank can reduce excessive loan concentration categorized by country, currency, industry, or maturity by selectively entering syndications with desirable portfolio characteristics. Increasingly, banks offset excessive credit risk exposure by purchasing credit default swaps and total return swaps, discussed more fully in Module 7.
A successful syndication progresses through a series of steps. The procedures are often comparable to a large domestic loan.

**Mandate:** The potential syndicator must first obtain a “mandate” from the prospective borrower. A mandate, if written, provides a legal document that gives the bank the exclusive right to approach other institutions to raise a certain amount of funds on behalf of the debtor.

**Marketing:** A syndicated loan must meet the needs and objectives of both the borrower and all participating lenders. The syndicator, sometimes also known as the manager, agent, or lead arranger, must balance the structure of the loan from the lenders’ perspective against the borrower’s goals. Lenders want higher fees, a larger spread above the reference interest rate specified, more collateral, and tighter protective covenants. The debtor wants lower fees, a smaller spread off the reference interest rate, less collateral, and less restrictive loan agreements. The manager provides information about the syndication to other institutions via an “offering telex.” The telex, which is sent electronically, conveys basic information about the loan and is considered an offer to participate. Later, the manager distributes a more detailed and lengthier “information memorandum” that contains additional material about the loan and the borrower. Once the appropriate parties sign the loan, the manager will advertise the deal via publication of a “tombstone” advertisement in the financial press.

**The Loan:** A loan agreement will specify many legal and operational issues that identify the responsibilities of the various parties to the agreement. Several additional issues apply to the syndicated loan. First, the commitment of the syndicate normally is “several,” not “joint.” This means the borrower may look to any syndicate member rather than all of the lenders for a drawdown. Second, the drawdowns are pro-rata among the lenders. As a result of these covenants, the manager must select participating banks that will remain viable and able to meet cash draws over the life of the loan. Third, the interest rate and repricing period, such as quarterly or semi-annual, must be specified.

**Monitoring:** Once the loan is committed and drawdowns are occurring, the loan must be serviced and closely monitored. The agent bank, which is not necessarily the manager or lead bank, is responsible for handling the operational aspects of the loan. This includes any required interest rate adjustments, interest collection, and payment and receipt of principal. The agent is also responsible for monitoring compliance with the terms of the loan agreement and for evaluating future trends that might adversely affect repayment. The agent bank retains operational and fiduciary responsibilities of the syndicate. Consequently, the participating banks must have confidence in the integrity and capability of the agent bank.

A syndicate normally includes several types of banks: a lead arranger or manager, an agent bank, collateral agent, co-managers, and participants. The syndicate must include a lead arranger or manager. The lead arranger obtains the mandate from the borrower and contacts the co-managers via the offering telex to put the deal together. Often, the agent bank is the lead arranger. The agent bank is also responsible for servicing the loan and later renegotiating the terms of the loan, if necessary. The syndicated loan allows participating banks a much better opportunity to work with a problem debtor than the global debt market. There may be ten participating banks in a syndication versus a thousand investors in a global bond.
The co-managers work closely with the lead arranger to sell participations to other institutions, which then fund the loan. The manager and co-managers may underwrite a loan until all participations are purchased. A loan is “underwritten” if the borrower receives funds prior to loan purchase by participating banks. A few weaker international loans are structured on a “best efforts” basis, whereby the borrower only receives loan proceeds if and when the participations are sold. A manager or co-manager is exposed to more credit and price risk with an underwritten loan because the manager has advanced funds to the borrower prior to receiving proceeds from the syndicate participants. The managers must closely monitor their exposure when underwriting an international loan in terms of credit risk, price, country exposure, and currency denomination. Exhibit 3.6 illustrates the relationship and responsibility of the syndicate members and fee-splitting arrangements common to the market.

Exhibit 3.7 - Syndicate Structure and Fee Splitting

Each syndicate is priced to include fees. The borrower typically pays the fees up front. As a result, the syndicate loan is comparable to a discount loan, whereby the fees are deducted initially from the proceeds of the loan. Fees are negotiable and subject to competition, but typically vary between less than one to more than three percent. A fee of 1.5 percent of the commitment is common. The fee on a $1 billion jumbo loan would amount to $15 million. The fees are allocated to the members of the syndicate based on a preset formula. The lead arranger or manager might receive 50 basis points, the co-managers receive 50 basis points, and the participating banks receive 50 basis points. A basis point is 1/100 of 1 percent. The lead arranger’s fee is split with an agent bank if the two are not the same institution. The lead arranger is entitled to the full 1.5 percent fee for that portion of the loan it co-manages and funds. The co-manager is entitled to a one-percent fee for that portion of the loan it retains.

The lead arranger and co-managers have a strong financial incentive to sell as much of the loan as possible. Fees substantially boost the potential profit for loans retained by the lead arranger or co-manager. For example, assume a syndicate lent a major borrower $1 billion at three-month Libor + 50
basis points for five years. The loan included 1.5 percent fees to be split: 0.5 percent to the lead arranger, 0.5 percent to the co-managers, and 0.5 percent to the participating banks. Assume that the lead arranger co-managed $200 million and retained $25 million of the loan. The lead bank would earn $5 million (0.005 times $1 billion) for being the lead arranger, $1 million (0.005 times $200 million) for being a co-manager and $125,000 (0.005 times $25 million) for being a participant. The bank earns fees of $6,125,000 million, which amounts to $1,225,000 million per year when amortized straight-line over the five-year term. The fees increase the effective annual return for the participation retained by almost 5 percent ($1.225 million/$25 million). The price effect is even greater on a present value basis because the fees are received up front. As indicated earlier, U.S. banks tend to earn relatively low rates of return on loans placed in foreign offices (e.g., 3 percent on international loans versus 7 percent on domestic loans). The fees earned from a syndicate significantly increase the total return from the international activity. It is important to note that banks incur costs when earning higher fees. The lead manager and/or agent bank must monitor the loan, inform participants of the borrower’s compliance with the loan agreement, identify deterioration of creditworthiness, renegotiate any changes, and service the loan. The lead bank, therefore, incurs additional expenses and is exposed to additional risks after the loan is underwritten. These risks should be anticipated within approved policy statements. International loan policies allow banks to establish a method to control risk exposure.

An international loan shares many attributes of a domestic loan. The credit analysis should investigate the character, capacity, and capital of the debtor. The note should require collateral and impose restrictive covenants to allow the agent bank to monitor and control risk. An international loan exposes a bank to country risk. The debtor’s accounting statements used to evaluate capacity and capital often differ from those of domestic borrowers. Legal differences can affect the capacity to borrow, the ability to pledge collateral, and the priority or preference of claims should liquidation become necessary. An international loan also exposes a bank to currency risk regardless of the currency of the loan. For example, a U.S. bank may originate a U.S. dollar-denominated loan to a Brazilian manufacturing firm. The debtor will find it more expensive to pay interest and to repay principal in dollars if the Brazilian real is devalued by Brazil or depreciates to the dollar in secondary market trading. After the Asian Crisis of 1997, many South Korean companies that borrowed short-term funds denominated in U.S. dollars at interest rates well below 10 percent owed global banks an effective rate exceeding 80 percent because the Korean won depreciated relative to the U.S. dollar. The policy statement adopted by a bank must recognize the basic principles of domestic credit, but also incorporate international nuances.
International Lending Policies

Commercial banks that suffer from excessive credit risk and high loan losses typically lack effective lending policies or effective credit administration policies. Once a bank determines that international lending is compatible with its business plan and operating strategy, management should prepare a written policy statement approved by the board of directors. The policy statement provides the framework by which a bank reaches decisions to make international loans, the process by which a bank structures a loan, and the plan for the bank to review its portfolio for compliance with internal policies and regulation. If a policy is to prove useful to management and the board of directors, it should reflect each of the following factors. The policy should be:

- consistent with the bank’s overall business plan and strategic operations;
- written by senior management and approved by the board of directors;
- realistic given the global economic, competitive and regulatory environment; and
- implemented by management and staff and reviewed annually by the board.

A policy statement is a critical component of risk management. Because most examiners are already familiar with domestic lending, this section provides a brief framework for evaluating international lending policies.

The Policy Statement

Banks draft policy statements with varying degrees of sophistication. The format of a policy is best left to managerial preference as long as it is comprehensive and consistent with the level and complexity of bank lending. A policy should cover the following topics.

- Loan officer approval limits
- Target customers and country risk limits
- Portfolio diversification objectives
- Hedging activity allowed to manage excessive levels of credit, interest rate, or foreign exchange risks
- Approved products and terms
- Pricing guidelines
- Collateral procedures
- Credit analysis and related files
- Regulatory compliance
- Insider-loan provisions
- Approval and review processes

Selected internationally active bank policy statements may be more structured than suggested by the prior listing of key points and address the following elements: personnel, products, portfolio mix, pricing, and procedures.
Personnel
A bank’s lending personnel need to fulfill roles of marketing, credit underwriting, lending, and reviewing. In some banks, a single officer may assume the responsibilities of the origination, credit, and loan functions while in other banks these roles may be delineated among departments. There are subtle differences between domestic and international lending.

Call Officer: A call officer, also known as an originator, normally contacts prospective borrowers who may require financial services offered by a bank. Call officers attempt to obtain business and placements on behalf of the bank. Because many international loans are syndicated, call officers must identify the lead arrangers or co-managers that typically put together deals compatible with the bank’s objectives. A call officer might contact another bank, a head of state, or a corporate CEO to obtain business. The call officer is responsible for initially judging the borrower’s character.

Credit Officer: A credit officer reviews loan applications and prospective offers to join a syndicate recommended by loan officers or loan committees. Credit officers attempt to ensure that any business that results in an extension of credit will be repaid in a timely manner. The credit officer must have a working knowledge of differences in international accounting conventions, documentation requirements, legal conventions, and country risk. The credit officer is responsible for ensuring the bank has fully evaluated capacity, capital, collateral, country risk, and currency risk. In addition, the credit officer must ensure the conditions within the loan agreement protect the bank.

Loan Officer: A loan officer retains individual responsibility for working directly with the international borrower or the syndicate. As such, the function combines aspects of marketing and credit analysis. The loan officer not only ensures each loan has several sources of repayment, but that the interest rate and fees are commensurate with the costs and risk of the loan. The loan officer must monitor the terms of the loan until all obligations are fully satisfied.

Review Officer: A review officer is responsible for ensuring that the bank’s approved policies and procedures are implemented and rigorously enforced. Is the loan consistent with the bank’s policies? Are all loans well documented? Are loan officers monitoring the loans? Is all collateral attached and perfected according to the requirements of the loan agreement and the host country? Have all problem loans been reviewed for possible classification and losses charged off? Are the allowance for loan losses and any allocated transfer risk reserve commensurate with the quality of the portfolio, historical trends, ICERC classifications, and other country factors?

Each bank must ensure that the education and training of international lenders is appropriate to their degree of responsibility. A policy statement may identify certain parameters applicable to personnel, including the following questions:

- **Experience:** What is the minimum level of experience, language fluency, and education required for officers and staff to assume international lending responsibilities? What type of continuing education program does the bank offer? Are the resumes and experience of all international lenders compatible with the policy?
- **Functional Responsibility:** Does the bank show evidence of analyzing credits and country risk prior to committing funds, monitoring credits until repaid, and reviewing all problem loans for
possible classification and charge-off? Does the bank separately review all problem loans with a review officer independent of the loan department?

- **Loan Limits:** Does each loan officer have a loan limit commensurate with experience? Is the limit reasonable given the operations and condition of the bank or office? Do limits vary according to the transfer, economic and political risks of a country? Are all large loans or participations reviewed and approved by a senior loan committee and/or loan committee of the board of directors? Is the limit within regulatory requirements? How are local office limitations assigned and monitored?

- **Loan Policy:** Has the board of directors approved a loan policy unique to the individual bank or office? Does a review officer ensure that the policy is implemented? Does the board review the policy at least annually based on the bank’s or office’s experience and evolving economic and competitive conditions in the local market?

- **Insider Loans:** Does the board have special procedures to evaluate and monitor any international loans related to insiders? Are these loans in compliance with applicable insider loan limits as dictated by regulation?

A bank can enter the international loan market very quickly by purchasing participations through syndications or through purchases in the secondary market. In situations of this nature, examiners should verify that appropriate risk controls are in place and compatible with the additional risks applicable to international lending. Examiners should be aware that a small regional bank that participates in these credits may have limited input into the overall structure and management of the loan. The ability of a bank to construct a balanced portfolio, lend to creditworthy prospects, price loans properly, and follow proper procedures requires well-trained and experienced personnel.

**Portfolio Mix**

Many large banks believe that international lending represents an important component of a business plan. Some banks enter international lending from a defensive perspective to better service existing domestic customers with expanding international operations. Other banks enter international lending from a strategic perspective to improve their risk-adjusted return on equity and/or to diversify and reduce portfolio risk. The policy statement must be written to allow the bank to achieve the goals of the business plan, which often affects the appropriate amount and mix of international loans.

International lending should complement domestic portfolio management. As such, the bank may impose a number of portfolio mix objectives or constraints within the policy statement. The importance of a particular constraint depends on the financial condition of the bank. Banking units with relatively lower amounts of capital must closely watch international loan growth and assigned or derived risk weights. Banking units should limit investment in countries or borrowers rated “BB/Ba” or lower by the international credit rating agencies. Institutions with heavy investment in countries that are assigned a country risk rating (i.e., not “passed”) need to direct more attention to country mix and limit commitments to countries with economic or political problems or low credit and regulatory ratings. Banks that fund assets in a currency different than that in which the loan is booked need to consider currency exposure. Those that mismatch the interest rate repricing schedule between assets and liabilities need to direct attention to the maturity, the reference rate and repricing interval used in syndicates. Finally, banks
committing to drawdowns for periods extending beyond one year need to consider liquidity more fully. International lending must complement domestic asset/liability management.

**Products**

There are several classes or types of international borrowers. The ability to make loans to all borrowers depends, in part, on the organizational structure of the bank and the expertise of personnel. Some banks without an international branch or facility will be unwilling to make loans to foreign individuals or loans in a foreign currency to global companies. Other banks that have invested in “brick and mortar” internationally will need to make such loans to justify the financial commitment and offset fixed operating costs.

The policy statement either may constrain international loans or encourage certain types of loans.

**Legal Status of Borrower:** A bank can easily limit international loans based on the legal status of the borrower. For example, a bank might only consider placing funds with its overseas branch or with the offices of other banks. Or a bank might not allow loans to foreign individuals or foreign governments.

**Condition of Borrower:** A bank might limit the placement of funds to countries, corporate borrowers, banks or bank holding companies, and/or guarantors that possess a high-grade, stand-alone credit rating (“AAA/Aaa” or “AA/Aa”) from designated rating agencies or the bank’s own internal ratings.

**Lead Arranger/Agent:** A bank might limit the placement of funds to syndications headed by banks annually approved by the board of directors. Given the importance of the lead bank and/or the agent bank to monitoring, servicing, and renegotiating international loans, this constraint reduces time required to review offering telexes of non-approved lead banks.

**Currency:** A bank might limit the placement of funds to US dollar-denominated loans and other currencies that are expected to retain strength, be less volatile, or reduce existing portfolio currency exposure.

**Loan Purpose:** A bank can limit the placement of funds to loans that have a well-defined purpose and multiple sources of repayment. For example, a bank might only enter into short-term working capital loans or intermediate-term infrastructure loans.

**Pricing**

If a bank elects to enter the international market, the loans must be priced to provide a sufficient return for the institution. There are many opportunities to participate in international loans. The policy statement should articulate how a bank prices a loan and determines whether the combination of fees and spreads are judged sufficient. The international syndicate market is very competitive. Certain banks have a cost advantage over other banks by obtaining funds at lower rates of interest or servicing loans at a cheaper functional cost. Not all banks are under pressure to provide an adequate risk-adjusted return on equity for their shareholders. What may be an adequate interest rate for a European money-center bank trying to increase asset size or an emerging market state-owned bank focused on obtaining new business may be an inadequate rate for a U.S. bank.
When pricing a loan, a bank should consider a variety of costs applicable to the loan. The interest rate must cover the cost of funding the loan with deposits or borrowed money consistent with the term, repricing, and currency of the loan. The interest rate must cover operating expenses to originate, monitor, and collect the loan. The interest rate must be sufficient to offset the debtor’s probability of default and loss given default. Finally, the interest rate must provide shareholders their required return on equity.

**Cost of Funds:** The loan should provide a rate of return that covers its cost of funds. The cost of funds approximates the bank’s marginal cost of funds with a maturity equivalent to the repricing schedule of the loan. If the loan’s interest rate resets every six months, the marginal cost of six-month funds should be used. The cost of funds should reflect the interest rate of the country in whose currency the loan is denominated. If the loan is funded and repaid in Swiss francs, the marginal cost of funds should reflect interest rates applicable to Switzerland’s money market. Otherwise, the interest rate misprices interest rate and/or currency risk.

**Functional Costs:** The loan should reimburse the bank for the functional operating expenses allocated to originating/purchasing, servicing/monitoring, and collecting/charging off the loan. Lead arranger banks will have higher operating costs than participating banks. The lead banks, however, also receive higher fees when the syndicate is formed. Given the large size of international loans and the predominance of syndicates, banks are able to achieve economies of scale. Larger loans can be originated at relatively lower proportional costs than smaller loans. Yet, larger loans may approach a bank’s legal loan or policy limit.

**Default Risk:** The loan should recognize potential default risk. The interest rate should include compensation for the probability that an international loan will default and cause a loss to the bank. The probability of loss varies according to the type of borrower, the credit quality of the borrower, the maturity of the loan, the country, the legal conditions of the note and trends within the global economy. According to a study conducted by Moody’s Investor Services published in July 2015, 3.43 percent of non-sovereign borrowers with a ‘B’ rating ended in default, but in 2012 it was only 0.27 percent. Given these differences, it is important for bank examiners to ask which default rate a modeler uses in his/her inputs in a credit risk or pricing model. Bankers need to be able to incorporate default probability and loss given default into their spreads. For example, if the default rate of a borrower is 1.5 percent and the loss given default is about 65 percent the spread above the reference rate of the loan must include 0.975 (1.5 percent probability of default times 0.65 loss given default).

**Profit:** The price of the international loan should include a profit sufficient to cover the cost of equity and provide an adequate return on equity for investors in line with the bank’s strategic profitability goals. Whereas most large, internationally active banks in the United States strove to earn a return on equity between 12 and 16 percent per year in the years leading to the 2008 crisis, in 2010. In 2015, the range had been about 8.96 to 9.19 percent.

**Policy and Procedures**
A bank’s policy statement must address minimum procedures to be followed when entering the international loan market. The policy statement should identify the sequence of required procedures from evaluating a prospective loan to charging off an uncollectible asset. The policy statement identifies the major activities, including credit analysis and underwriting, loan monitoring, and portfolio review.
The most important ingredients to a successful international lending program are the policies and procedures guiding personnel in daily operations. Lending personnel, in addition to extending credit, are responsible for completing numerous tasks such as contacting prospective borrowers, responding to offering telexes for syndicates being formed, evaluating credit and country risk, recommending pricing, structuring loan agreements, monitoring repayment progress and compliance with terms, servicing the loan, reviewing, classifying and/or restructuring problem loans, and executing charge offs for uncollectible loans.

**Credit Analysis:** A bank’s lending policy should identify the required components of credit analysis applicable to evaluating a loan. International lending must direct special attention to country risk and to currency risk. The credit analysis normally includes several interconnected reviews: loan purpose analysis, loan repayment analysis, and loan structure analysis. These factors were covered earlier in this Lesson.

**Monitoring:** A lending policy must specify minimum monitoring procedures. Monitoring can broadly be defined to include servicing the loan, setting up files to ensure all covenants of the loan agreement are complied with, conducting periodic visits with the debtor, updating credit analyses of the borrower and country, and releasing the note and collateral when fully paid. International financial statements are often only available on a semi-annual or annual basis. Consequently, a fully updated credit analysis may be required semiannually or annually. The loan file should include evidence of monitoring by the agent bank and the participating bank.

**Reviewing:** A lending policy must identify minimum review procedures. Designated officers of the bank, an internal audit function, or outside professionals may accomplish the review. Are all problem loans given special surveillance? Does the bank have and follow appropriate internal controls, including segregation of duties? Is the board informed of all material factors applicable to the international loan portfolio? Are loan fees and income correctly reported? Is the allocated transfer risk reserve adequate and consistent with ICERC? Are required reserves established? Have problem loans been classified internally? Does senior management relate deficiencies found during the review process to revisions needed in the loan policy or weaknesses in credit administration? The review process closes the loop between establishing a policy and ensuring its effective implementation.

**Special Provisions:** Some banks will recognize special factors within their policy. For example, a bank might prohibit certain types of loans or loans to certain countries. A bank must require a special approval process for loans to insiders or political leaders. Special provisions are unique to each bank.

**Internal Controls:** The review function must ensure the bank is adhering to sound internal controls, which are illustrated by the following questions.

- Are loans made only in accordance with policies established by the Board of Directors?
- Are credit reports obtained and country reports updated for new loans?
- Are loans properly approved by officers and, if required, reviewed by a loan committee?
- Is the performance of three functions—loan approval, disbursement and collection, and ledger posting—appropriately segregated among different employees?
- Is cash disbursement of loan proceeds to the borrower prohibited?
- Is physical protection of notes, collateral and supporting documents adequate?
• Are ledger trial balances frequently prepared and reconciled with control accounts by employees who do not process or record loan transactions?
• Are “paid” notes cancelled and returned to the borrowers?
• Are supporting documents on new loans inspected for proper form, completeness and accuracy by someone other than the lending officer?
• Are loans reviewed on a timely basis for collectability, write-offs recorded where applicable, and the allocated transfer risk reserve evaluated properly?
• Do personnel show evidence of monitoring syndications (borrowers and agent banks) until repaid?
• Does the bank limit the amount of credit—individually and by country—that can be lent by an officer, office or branch?
• Do the employees of each office know the bank’s policies and procedures, and direct attention toward internal control compliance?

Overall, there are more similarities than differences between domestic and international lending. However, country risk is a major distinction.
Country Risk

Country risk is comprised of sovereign risk, political stability, transfer, expropriation, exchange controls, internal or external conflict, and corruption. Also included in country risk is whether the country’s legal system can be relied on to protect the interests of foreign creditors, including access to collateral. Losses related to country risk can lead to reputation problems. Country risk also refers to the manner a government will respond to external economic pressures. Is a government likely to repudiate debts or expropriate assets when confronted with massive fiscal deficits, a domestic banking system catastrophe or a currency crisis? Does the government face significant internal dissent? Qualitative models that include trend analysis and country-specific analysis typically measure political risk.

Economic risk represents the country’s fiscal and monetary environment. Is the country in a recession, losing jobs, running excessive fiscal deficits, experiencing massive monetary growth, or incurring substantial inflation? Economic risk normally is measured by quantitative models that recognize the business cycle and the fiscal, monetary, and inflationary conditions and trends of a country.

A part of country risk is transfer risk, also known as exchange controls risk, which represents the ability of a foreign borrower to obtain the appropriate currency to repay a loan. Is the government likely to impose currency exchange controls? How do the current reserves of a country and sources of currency from exports compare to currency payments related to imports and foreign currency-denominated debt? Banks must monitor, measure, limit, and diversify country risk. Banks should closely monitor portfolio exposure to countries that suffer from economic problems, political instability, or likely exchange controls. Transfer risk typically is measured by a combination of subjective and quantitative models that reflect the possibility of currency exchange controls being implemented. The final section of the Lesson covers issues applicable to country risk and the allocated transfer risk reserve banks are required to establish against loans to substandard, value impaired, and loss global assets. In February 2016, the Office of the Comptroller of the Currency released its updated Country Risk Management Handbook. This handbook is extremely useful guidance not only for bank examiners, but also for risk managers and auditors at banks.

Sovereign Risk
This is an extremely important component of country risk because it reflects the ability and willingness of a sovereign to repay the country’s debts in a timely and complete manner and to support its banking system, as needed.

Expropriation: A government may seize private property owned domestically without any compensation or without fair compensation. A bank often bases its estimate of repayment of a loan from the cash flow generated by private property. The property also may serve as collateral for the loan. The property can be a major asset of the borrower, and if it is seized without fair compensation, the borrower’s capacity, capital, and collateral will be impaired, with adverse effects for the repayment of the international loan.

Nationalization: A government may nationalize assets seized by expropriation or confiscation. When a business is nationalized, the government assumes its management. If the debts of the company are then
repudiated or restructured, or if the company is unable to generate adequate cash flow to service the loan because of governmental mismanagement, a bank will suffer an economic loss.

**Political stability:** Governments subject to frequent and violent changes in control or subject to war present banks with more country risk. Governments unfriendly to the lender or countries that have a poor relationship with the lender pose additional risk that may prevent the repayment of loans placed by global banks.

A bank should monitor the nature of a country’s government if it expects to remain an active international lender. For example, do the government elite comprise technocrats, or is it formed by a political patronage system? Is decision-making power diffuse and local, or is it centrally located? Countries that are judged riskier should be evaluated more closely and continuously than stronger and more stable countries. A bank may elect to prohibit loans to very risky countries and limit exposure to weaker countries. Project financing in such countries can be particularly subject to such risks.

A bank active in international lending must also assess political stability. What factors will challenge a government’s ability to maintain its political power and how will the government react to those forces? Will a country risk international sanctions to intervene in a neighboring country’s civil war? Will a sudden decline in portfolio investment spur a government to undertake a reform program or to recapitalize hard-hit industries? What is the probability of a change in the structure and control exerted by a government? Banks may limit international loans to a very low percent of capital for countries that are subject to adverse political change.

Banks must apply their assessment of political risk to the sectors in which their clients are active. Investments in certain regions may be riskier than in others if a government perceives a political reason to differentiate between industries. For example, foreign investment in the banking sector may be seen as a threat to an extensive political or familial network, while the telecommunications industry may be relatively free of patronage and consequently not as subject to threat of nationalization or confiscation.

Exhibit 3.8 illustrates some of the qualitative elements of political risk and the related factors that affect government stability. Evaluating a government in terms of its likely reaction to the pressures it faces allows for the assessment not only of the current condition of a country but also for predictive analysis of how the risk profile of the country may change.

Political risk intertwines with economic risk, and political considerations often motivate a government’s economic policies. Countries such as Argentina, Ukraine, Iraq, Chad, Cuba, and Cambodia have been recognized as politically unstable. Given the continuing changes in government from Central and South America to Europe, Asia, or Africa, international loan repayment can quickly shift because of political risk factors.
**Exhibit 3.8 - Government Characteristics and Pressures**

<table>
<thead>
<tr>
<th>Governmental Characteristics</th>
<th>Riskier</th>
<th>Less Risky</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer of power</td>
<td>Opaque</td>
<td>Transparent</td>
</tr>
<tr>
<td>Decision-making</td>
<td>Diffuse, local level</td>
<td>Centralized</td>
</tr>
<tr>
<td>Governmental elites</td>
<td>Politicized</td>
<td>Technocratic</td>
</tr>
<tr>
<td>Legislating/enforcing/arbitrating</td>
<td>Not separate functions</td>
<td>Segregated functions</td>
</tr>
<tr>
<td>Political violence</td>
<td>Actively used</td>
<td>Not used</td>
</tr>
<tr>
<td>Corruption</td>
<td>Pervasive, accepted</td>
<td>Controlled</td>
</tr>
</tbody>
</table>

**Pressures**

- Internal dissent (opposition parties, coalition parties, student groups, military, unions)
- External threats (border disputes, skirmishes)
- Relations with international community (IMF/World Bank lending conditions, UN/unilateral sanctions)
- Demographic issues (multiple ethnic groups, rural/urban inequalities)
- Environmental issues (depletion of resources, reliance on polluting energy sources)

Corruption can also be a significant number of countries. Transparency International, a not-for-profit organization publishes a yearly Corruption Index. Participation corruption or bribery by a U.S. company, bank, or citizen is prohibited under the Foreign Corrupt Practices Act.

**Economic Risk**

The number of banks liquidated in the United States has long been correlated with the condition and trends of the U.S. economy. Banks with poor management and inadequate risk management systems are more likely to experience sufficient credit losses to dissipate earnings and capital after a recession, an increase in the civilian unemployment rate, or an increase in inflation-adjusted interest rates. Similar types of relationships occur internationally.

If a country is experiencing a recession, private and governmental debtors will be less able to generate cash flow to service a loan. If a government takes on too much debt or too much short-term debt from poor fiscal management or the central bank allows the money supply to increase too rapidly, a country may experience high inflation, which adversely affects the country’s currency value. Alternatively, if a country is experiencing a recession and aggressively reduces government expenditures without instituting long term systemic corrections, the recession may reoccur or be extended. If a country is importing
significantly more goods and services than it is exporting, it may be unable to obtain enough foreign currency to support repayment. All these factors comprise economic risk.

A bank should monitor the economic condition and governmental policies of a country to ensure that borrowers located in the country will retain the ability to repay a loan. Some bankers compare gross domestic product to a country’s current account, foreign-currency denominated debt or governmental debt to quantify economic problems. Some countries experience a current account deficit and often retain a large amount of foreign denominated fiscal debt with short-term maturities. Regardless of ratio or relationship, the following economic factors affect country risk from an economic perspective.

**Gross National Product (GNP)/Gross Domestic Product (GDP):** The overall condition and trend of a country can be evaluated by monitoring the gross national product and gross domestic product. A country’s GNP represents the sum of personal consumption, private domestic investment, net exports of goods and services, and governmental purchases. GDP omits earnings derived globally and measures domestic output. If a country is experiencing a decline in output, it may be less able to service debt and may become more susceptible to civilian unrest and political change.

**Fiscal Policy:** The fiscal policy of a country represents the purchase of goods and services by the government and the method of payment for the goods and services. Government purchases comprise a part of GNP or GDP. Governmental purchases can be financed by taxes, deficit financing, or confiscation/expropriation methods. Countries running large fiscal deficits typically require financing by domestic or international sources. Repayment problems can occur quickly if a fiscal deficit is financed mostly by issuing short-term debt internationally or by the central bank printing money. A bank should attempt to identify how the fiscal deficit is managed. To maintain membership in the European Union, countries must maintain a fiscal deficit less than three percent of GDP and not allow the federal debt to exceed 60 percent of GDP. Countries, such as Greece Spain, Portugal and Italy, have violated the EU fiscal standards and are viewed as riskier than those countries exhibiting fiscal prudence such as Germany or Austria.

**Monetary Policy:** The monetary policy of a country represents the actions taken by its central bank to control the supply of money and credit. Monetary actions can influence inflation or deflation, which ultimately affect interest rates and the value of a foreign currency. Higher interest rates can impede the ability of a debtor to repay floating-rate loans common to the international market or short-term loans typical of emerging markets. Inflation can lead to depreciation or devaluation of currency, which also complicates debt repayment. Some central banks in Eastern Europe periodically purchase all securities issued by the country and monetize the debt, resulting in rapid money growth and inflation. It is critical that a central bank act to provide adequate liquidity to support sustainable growth in a country but limit inflation to five percent or less per year. Although the market fears inflation, deflation can be as debilitating to economic growth. Japan has experienced deflation early in the 21st twenty-first century. Deflation encourages prospective investors to defer the purchase of real assets, which adversely affects GDP growth. Deflation reduces the value of bank collateral, and loan defaults result in larger losses than projected from historical experience. Some monetary problems occur because the central bank lacks independence from the government.

**Banking System:** Most emerging markets lack well-developed money and capital markets. Yet since 2008, growth and deepening of markets is being seen in the capital markets of a number of key emerging
markets such as Mexico, Brazil, China, and India. The banking system intermediates funds between surplus savers and deficit borrowers. The central bank often regulates and supervises banks in the country. If the banking system is not safe, it is unable to attract savings and make loans. The lack of credit leads to economic problems. Some countries, such as China, India and Brazil, have many state-owned banks. Government-owned banks are often directed by the government to make loans to sectors, firms, and individuals favored by government policy. Such loans, even if clearly uncollectible, may not be subject to classification if the banking regulator does not retain independence from the administration.

**Trade/Capital Account Balance:** A country will need to borrow internationally to manage either a trade or a capital account deficit. If the deficit becomes too large in relation to the ability of the country to service the debt, a bank may find it has to reschedule its international loans.

The economic statistics that portray financial condition vary from country to country, even among industrialized nations. Several independent rating services view countries, such as Cuba, Afghanistan, Congo (formerly Zaire), and North Korea, as high risk.

Many banks active in international lending have developed credit scoring systems for assessing economic risk. These scoring systems include statistical indices that reflect governmental policy and other financial indicators on foreign-denominated loans, such as:

- \((\text{Annual Debt Service} + \text{Short-term Debt}) / \text{Total Exports}\);
- \(\text{Total Debt} / \text{Total Exports}\; \text{and}
- \(\text{Per capita income}\)

Countries with more debt, fewer exports to generate foreign currency and cash flow, or less income per person are rated as riskier. Banks should exercise additional caution when lending to countries with weak or deteriorating economic conditions. Countries whose economies are “booming” at unsustainable growth rates are susceptible to severe economic problems when a later “bust” occurs. Countries that rely on one principal industry, such as mineral extraction, oil and gas or forestry, are riskier than countries with diversified industries. Economic conditions affect both political risk and transfer risk.

International rating agencies, such as Fitch, Moody’s and S&P, evaluate the credit risk of sovereign debt placed globally. As of December 2015, only Canada, Germany and Switzerland were rated AAA by all three major global credit rating agencies. Countries such as the U.K. and the U.S. were rated high-grade with a credit rating of AAA or of AA+. The U.S., however, was downgraded by Standard and Poor’s on February 22, 2013 to AA largely due to political stalemate in the U.S. Moody’s downgraded the UK also on February 22nd, to Aa1 citing a slow economic recovery and high debt levels. Fitch also downgraded the UK to AA+ on April 19, 2013 citing a weaker economic and fiscal outlook. Other countries, such as Israel and the Special Administrative Region of Hong Kong, were rated medium-grade or A+ and AA+, respectively. Select countries, such as Bolivia and Pakistan, were rated low-grade or BBB- and B-, respectively. Unlike the mid 2000’s, when a few emerging market countries, such as Cuba, Ecuador, and Moldova, were rated near default with a CCC/Caa rating, as of December 2015, Greece, with a B-, CCC, and C, had worse ratings than Argentina.

- [www.Fitchratings.com](http://www.Fitchratings.com)
- [www.moodys.com](http://www.moodys.com)
Per Capita Income: Countries whose citizens enjoy a high standard of living are less prone to civil unrest. People that are more prosperous are better able to afford education and health care, which leads to higher productivity. As shown, AAA countries posted a weighted average per capita income of U.S. $47,600 versus $33,167 earned in A countries.

Inflation: Countries that experience low inflation carry lower nominal rates of interest; borrowers are better able to meet contractual interest on loans. Low inflation also maintains the value of a country’s currency. AAA countries posted average inflation rates over a five-year period of 22.5 percent while B countries suffered an almost 7 percent annual inflation rate.

Unemployment Rate: Countries rated AAA maintain high employment for their citizens; high-grade countries post an unemployment rate less than 10 percent, in comparison to before the crisis when it was less than percent. High unemployment not only causes economic problems (citizens pay fewer taxes and require more social support), but it can also precipitate political issues and civil unrest.

Fiscal Balance/GDP: Before the crisis, AAA countries on average generated fiscal surpluses equal to one-half of one percent of GDP. Since the crisis, particularly with the U.S., UK, and Canada having current account deficits, some AAA countries have a deficit despite significant surpluses in Germany and Switzerland. Some emerging market countries like China, Estonia, and Israel were running current account surpluses as of December 2015. Low rated countries incur fiscal deficits that exceed 7 percent of GDP. The fiscal deficits put pressure on the central bank to print money or for the country to borrow funds domestically and internationally.

As conditions evolve, the credit rating agencies change the credit rating of a country. It is important to note that ratings should only be viewed as one tool to assess a country’s sovereign risk; market participants should always conduct their own due diligence. Market participants also look at bond yields and Credit Default Swaps (CDSs) spreads to develop a market implied probability of default. Prices of loans increase when a rating upgrade is likely, and prices decrease when a rating downgrade occurs or is expected. The market normally is able to forecast a credit rating change, and loan prices often shift prior to the announcement by the rating agency.

Country risk reflects many other issues besides those reviewed. For example, given the absence of a long-term capital market for many emerging markets, the rating agencies focus on the safety and soundness of a country’s banking system.

Rating agencies also direct attention to the legal and regulatory system in a country. Are the courts fair and independent? Does the government promote high ethical standards for both business and governmental leaders? Are banks and corporations encouraged to adopt effective and comprehensive corporate governance programs? Many countries in Africa, Asia, South America, and the Middle East are viewed as having high legal risk.

In addition to rating agencies, other entities also evaluate the financial sector and banking systems globally. The World Economic Forum, for example, publishes The Global Competitiveness Report (GCR) annually. This report analyzes the financial system of each country and region. The latest
available report is from 2019. At that time, the safest financial system was in East Asia and the Pacific, followed by North America and Europe.

**Exhibit 3.9 – Regional Performance by Pillar**

Average score (0–100)

<table>
<thead>
<tr>
<th>Region (alphabetical order)</th>
<th>Enabling Environment</th>
<th>Human Capital</th>
<th>Markets</th>
<th>Innovation Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>East Asia and the Pacific</td>
<td>61.6 74.8 70.3 89.6</td>
<td>83.8 67.3</td>
<td>62.2 66.6 74.3 67.9</td>
<td>66.1 54.0</td>
</tr>
<tr>
<td>Eurasia</td>
<td>53.8 67.7 59.5 74.9</td>
<td>71.3 66.1</td>
<td>56.1 63.5 52.0 50.3</td>
<td>61.9 35.5</td>
</tr>
<tr>
<td>Europe and North America</td>
<td>64.7 79.7 70.4 92.6</td>
<td>89.1 74.6</td>
<td>60.0 66.4 70.9 60.1</td>
<td>68.3 58.1</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>47.1 61.3 50.9 73.7</td>
<td>82.2 58.7</td>
<td>51.6 55.9 60.3 51.2</td>
<td>53.8 34.3</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>55.5 70.5 57.8 75.3</td>
<td>80.8 62.9</td>
<td>56.7 54.8 63.7 59.9</td>
<td>58.2 41.3</td>
</tr>
<tr>
<td>South Asia</td>
<td>50.0 59.2 35.1 74.7</td>
<td>68.4 50.1</td>
<td>45.8 51.5 60.0 67.7</td>
<td>57.8 36.3</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>46.9 45.0 34.3 69.4</td>
<td>50.8 44.3</td>
<td>49.3 54.6 50.8 40.4</td>
<td>51.8 29.4</td>
</tr>
</tbody>
</table>


Exhibit 3.10 illustrates the GCR’s 2019 ranking of the top banking systems throughout the world. The US presently ranks as number 25 in terms of soundness of the banking system.

**Exhibit 3.10 - Soundness of Banks by Country**

<table>
<thead>
<tr>
<th>Country</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finland</td>
<td>1</td>
</tr>
<tr>
<td>Singapore</td>
<td>2</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>3</td>
</tr>
<tr>
<td>Chile</td>
<td>4</td>
</tr>
<tr>
<td>Australia</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: Global Competitiveness Report 2019

**Transfer Risk**

If a country is not generating sufficient foreign exchange from exports and other sources, a global borrower may be unable to convert its local currency to service an international loan. Transfer risk arises either when a borrower incurs a liability in a currency that is not the currency in which revenues are generated or when a bank makes a loan in a currency other than its home currency (see discussion of “blocked exchange” below). The central bank must then obtain foreign currency on behalf of the
borrower. In some cases, a central bank may be unable or unwilling to intervene in the currency markets. In other cases, its intervention may lead to the depreciation or subsequent devaluation of the borrower’s currency, which can greatly increase the cost of financing and precipitate default.

A bank committed to international lending should distinguish transfer risk from economic risk. For any given international loan, the two factors are related but different. Economic risk refers to the inability of a country to generate cash flow to service the loan. Transfer risk refers to the inability to repay the loan in the currency required.

**Cross-Border Exposure:** International lending may result in cross-border exposure, which exists whenever a subsidiary or branch of a bank holding company or bank is funded from one country and lends, invests, places, or extends credit to any organization located outside the bank’s national borders. The exposure exists whether the credit is denominated in the host currency or any other currency. If a foreign branch funds an international loan in the host country’s currency, there is no cross-border exposure. However, cross-border credit risk would still exist.

**Local Currency Exposure:** The local currency exposure of a bank refers to the amount of assets and other non-balance sheet items that are subject to country risk and are denominated in the local currency of that country.

**Intra-country Foreign Currency Exposure:** The local currency exposure of a bank or bank holding company may include intra-country foreign currency exposure. Intra-country exposure exists whenever a subsidiary or branch of a holding company or bank lends, invests, places, or extends credit to entities that are located within the same country as the booking unit, but in a currency different than the country where the borrower and booking unit are located. For example, a branch of a U.S. money-center bank located in Milan, Italy, might lend Swiss francs to a borrower located in Northern Italy.

To illustrate transfer risk, assume that an U.S. money-center bank conducts business through a Brazilian subsidiary. As long as the subsidiary’s assets and liabilities are denominated in the Brazilian real and conducted with companies headquartered in Brazil, there is no transfer risk for the subsidiary. The money-center bank (not the subsidiary) is subject to transfer risk if Brazil imposed foreign exchange capital controls that prevented the repatriation of profits earned by the subsidiary. The bank is also subject to political risk if the government expropriated its assets of one of its subsidiaries or borrowers.

A government may take various actions that restrict the free flow of currency into or out of a country.

**Blocked Exchange:** Periodically a government may “block” a currency. This occurs when importers and borrowers who desire to make payments abroad are prohibited from purchasing the desired foreign exchange. Under these conditions, deposits in a local currency are made to cover the required remittances. Foreign creditors must wait until the block is removed or find some way of using the local currency to receive compensation.

**Multiple Currency System:** Sometimes a country tries to encourage the importation of certain goods or services by establishing a law that varies the exchange rate by type of goods. For example, a country such as the Philippines might peg 50 pesos per U.S. dollar for “undesirable” goods, and 45 pesos per dollar for “favored” goods. The multiple currency rules can also apply to the purpose of loans. Some loans, such as
those supporting exports or agriculture, might qualify for a preferable currency quote. If it is more expensive for a company to buy foreign currency, there is a higher probability of late or non-payment.

**Foreign Exchange Rationing:** A government may control foreign exchange by requiring that all holders of bills of exchange relinquish them to the government at a stipulated rate of resale. All importers must apply for bills of exchange from the government. The government then allocates the currency to importers or creditors whose activities governmental leaders wish to encourage. The government thereby rations foreign exchange based on internal social, external economic, or political favor criteria. Argentina is a current example of this.

To summarize, country risk refers to the combined political, economic and transfer problems that may prevent repayment of an international loan. Country risk differentiates international lending from domestic lending. Country risk can lead to severe reputational problems of a global bank.

**Supervision and Regulation**

The Interagency Country Exposure Review Committee (ICERC) was established in 1979 to administer the country risk supervision program of the Federal bank regulatory agencies in the United States. The ICERC meets once a year and is composed of senior bank examiners and staff members from the Federal Deposit Insurance Corporation, the Federal Reserve System and the Office of the Comptroller of the Currency. The committee also endeavors to hold a mid-year conference call to discuss any emergency issues or procedural matters.

The ICERC reviews defaulted countries to which U.S. banks have had an aggregate exposure of $1 billion or more for at least two consecutive quarters. In addition, countries to which aggregate exposure is between $200 million and $1 billion are reviewed by the ICERC if the exposure at five or more U.S. banks exceeds 25 percent of capital (Tier 1 capital + the allowance for loan and lease losses).

It reviews the risk of select countries to which U.S. banks have a significant credit exposure. The ICERC enables the agencies to centralize decision making, ensure uniform treatment of foreign lending, and conduct an efficient supervisory review of transfer risk.

The ICERC bases its decisions on a wide variety of information, including:

1. various economic ratios that measure a country’s debt burden, historical record of performance, and capacity to service the debt;
2. country risk analyses prepared by economists with the Federal Reserve Bank of New York;
3. reports prepared by the international economists with the Department of Treasury that evaluate economic conditions and the country’s standing with the International Monetary Fund (IMF); and
4. reports by examiners making bank visitations to review cross-border exposures and country risk management programs.

Based on these and other sources of information, countries are either not rated or placed into one of the following categories of adverse classification: substandard, value impaired, or loss. The ratings are comparable, but still distinct, from normal commercial credit classifications. The country risk ratings deserve additional definition.
- **Substandard:** The substandard classification is applied when a country is not complying with its external service obligations, and the country is not in the process of adopting a suitable economic adjustment program. The classification is also applied when a country is not meeting its obligations and the country, and its creditors have not negotiated a viable rescheduling program and are unlikely to do so in the near future.

- **Value Impaired:** The category of value impaired applies when a country has protracted economic and financial problems and exhibits more than one of the following conditions. First, the country has not paid interest for six months. Second, the country has not complied with IMF programs and there is no immediate prospect for compliance. Third, the country has not met rescheduling terms for over one year. Fourth, the country shows no definite prospects for an orderly restoration of debt service in the near future.

- **Loss:** This category applies when an international loan is considered uncollectible and of such little value that its continuance as a bankable asset is no longer warranted. For example, a country might repudiate its obligations to a bank or the IMF.

The International Lending Supervision Act of 1983 requires a bank to either establish a reserve against or charge off certain international exposures. This reserve, called the Allocated Transfer Risk Reserve (ATRR), is distinct from a bank’s general allowance for loan losses. The amount of the reserve or charge-off is mandated by ICERC and typically ranges between 10 percent and 90 percent of value impaired assets. An asset classified loss must be fully charged off. The ATRR is a specific reserve and a contra account to international loans and does not qualify as capital for a bank’s regulatory requirements.

Assume a bank purchased a US $10 million syndicated loan that later develops problems and is classified value impaired. Further, assume that ICERC mandates a 50 percent reserve as appropriate. Finally, assume that the bank has already charged off $2 million of the $10 million loan. Under these circumstances, what is the bank’s required level of ATRR or charge-off? The global bank requires an ATRR of $5 million, given the 50 percent reserve and $10 million exposure. The bank needs to reserve $3 million, not the entire $5 million, because bank management already recognized a $2 million loss.

The federal banking agencies are not only interested in ensuring banks recognize deterioration in international loans, when appropriate, but that bankers also limit concentration. Regulatory agencies prefer banks to diversify their portfolio of international loans and securities. Long-term loans to weak countries expose the bank to transfer risk for a longer period than short-term loans to strong countries. Because even developed countries can deteriorate, examiners must carefully judge whether a bank has an excess concentration in a particular country or region.

Regulatory standards clearly encourage banks to diversify their international loan and security portfolios. Strong and moderately strong countries can deteriorate and later cause significant problems for a bank. For example, the credit rating of South Korea plunged from A to BB in less than one quarter in 1997. Japan’s credit rating declined from a high-grade AAA to a medium-grade “A” over several years. An institution may avoid the consequence of impairing capital by diversifying the portfolio across a variety of countries and regions. For diversification to prove effective, country risks of new credits must not be highly correlated with existing investments. A bank should be able to demonstrate the process that management and the board of directors use to monitor, manage, and limit country exposures. Regulatory
guidelines for managing country risk are set forth in the Interagency Statement on Sound Country Risk Management Practices. Considerations include the following measures:

**Country Risk Studies:** A bank should not only evaluate credit, market, liquidity and operational risks, but also assess country risk prior to committing funds to the international market. Banks may prepare or rely on commercial country risk studies that identify the relative political, economic, and transfer threats for each country. Examiners must be satisfied that the quality, objectivity, and timeliness of the country risk studies are adequate and updated on a regular basis.

**Exposure Limits:** Banks can reduce their risk by diversifying the loan and investment portfolio. Domestically, banks often establish limits regarding the proportion of loans by industry or by geographical location. Regulations may limit the amount of unsecured loans to any single borrower to some percent of capital and surplus. Examiners should note that not all countries apply the same loan-to-one-borrower limits imposed in the U.S. For example, banks in Poland allow their banks to make commercial real estate loans to one borrower equal to 100 percent of capital and surplus versus 15 percent or 25 percent more common in other countries. Given the additional hazard introduced by country exposure, banks may limit the amount of loans to any single country or region of the globe. Examiners must evaluate the procedures the board of directors and management use to establish country limits. Limits may differ by bank and reflect the bank’s capital, existing asset quality, and liquidity, in addition to relative country risk and the correlation with other countries’ economies.

**Reporting System:** The effectiveness of any policy depends on the bank’s system of internal controls and reporting. Examiners must evaluate the adequacy of the managerial reporting system and ensure that the board of directors utilizes the reports to monitor and control country risk exposure. Banks are often required to submit a series of reports to bank supervisors that identify country risk exposure.

Regardless of methods used to manage country risk, banks must anticipate some problems.

**Managing International Loan Problems**

International loans that reflect only credit risk weaknesses are managed like any domestic problem credit. International loans facing transfer risk and/or country risk problems, however, are often handled under broad management and/or governmental plans. All of these debt management programs have certain provisions in common with one another. First, the plans attempt to reduce the repayment obligation of a country by reducing the debt owed or interest rate specified. Second, the plans attempt to lengthen the period over which existing debt must be repaid. Third, the plans increase the amount of loans to be advanced to the country, which allow the country to repay a part of the existing debt. The plans rarely allow a bank to escape recognizing a loss, where appropriate.

The major mechanisms structured to manage problems related to country risk include the following plans.

**The Baker Plan:** The Baker Plan was first proposed at the IMF/World Bank meetings in 1985 by then Secretary of the Treasury Baker. The Baker Plan encouraged banks and the IMF/World Bank to jointly increase lending to countries undertaking prudent measures to increase productive growth, especially exports. The Baker Plan proved to be unsuccessful as measured by any meaningful increase in lending for almost all countries except Mexico.
**The Brady Plan:** The Brady Plan was proposed in 1990 by then Secretary of the Treasury Brady. The initiative sought to ease the increasing debt burden of emerging markets and less developed countries by offering relief to those governments who instituted market-oriented reforms.

For example, a voluntary program was implemented in 1990 by Mexico and offered bank creditors three alternatives: 1) reduce principal by 35 percent; 2) reduce interest rates from a floating-rate set at Libor + 13/16 percent to a fixed-rate of 6.25 percent; or 3) make new loans equal to 25 percent of its outstanding Mexican debt. Similar agreements have been affected for other countries, such as the Philippines and Venezuela. The Brady Plan attempted to reduce the debt service requirements of a country and/or provide new loans to service existing obligations.

**Debt Swaps:** Given the development and growth of a secondary market for international loans, some banks have restructured their portfolios to reduce excessive exposure to certain countries. Two banks may swap low-grade emerging market loans based on the prices quoted in the secondary market.

For example, assume the price for loans to Argentina is 40 and the price for loans to Chile is 80. A bank might swap $200 million par of Argentina debt for $100 million par of Chile debt. The swap allows the banks to shift the composition of their debt by country, borrower, or maturity.

**Debt-for-Equity Swaps:** Rather than swapping debt for debt, some banks have swapped debt for equity. Banks may sell international loans at a discounted price to a global company, rather than another bank. The company then converts the country’s debt into local currency at the nation’s central bank. Finally, the company invests the currency into equity of firms of the country. The transaction reduces the financial leverage of overly burdened countries. Debt is extinguished and new equity investment is provided.

**Exit Bonds:** Some smaller banks have been reluctant to make new international loans suggested by the Baker and the Brady plans. A few countries, such as Argentina, have developed “Exit Bonds.” In this arrangement, banks may agree to accept low-interest government bonds equivalent to a portion of their existing bank debt. The lower interest, smaller face value, and longer repayment period facilitate debt management by the country. Some of the exit bonds have principal backed by zero-coupon U.S. Treasury bonds. The collateral does not protect repayment of interest, which can be sizable over a 30-year term.

**Retiming:** A few countries, such as Chile, have restructured the timing of their bonds. The country pays interest annually instead of semiannually. The extra six months provides a limited amount of fiscal relief to a country.

**Early-bird Special:** Some countries encourage banks to make new loans quickly in exchange for a higher interest rate. Banks first agreeing to offer new loans receive a higher rate of interest, which allows the loan package to be completed in a timelier fashion.

**Buy Back:** Numerous countries, including Mexico and Brazil, have been able to entice investors to tender Brady Bonds whose principal is secured by U.S. Treasury bonds for longer term, unsecured international bonds. Investors are rewarded with a higher yield on the new bonds, but are exposed to more price volatility given the higher effective duration of the bonds versus the loans and lesser protection of principal. Effective duration refers to the price sensitivity of a bond and is more fully discussed in Lesson 6.
Some banks have tried to generate immediate income by charging and booking fees connected with a restructuring program. Banks can charge fees when restructuring a problem international loan, although they must amortize any fee in excess of administrative costs over the term of the restructured loan. For example, suppose a syndicate charged a country a two percent fee for structuring a debt-relief package. If the banks were able to demonstrate they incurred administrative costs of one-half of one percent to restructure the loan, they must amortize the remaining 1.5 percent over the term of the restructured loan. Because many debt-relief plans include a longer repayment schedule than the original loan, the amortization of fees must be extended accordingly.
Summary

Although many country borrowers have turned to the securities market to obtain funds, large corporations and selected sovereign borrowers still rely on syndicated international loans. The need for global credit rises when a country is growing quickly. Growth requires firms to invest in new working capital and expand plant and equipment. Retained earnings often prove insufficient to meet funding needs. Newly privatized entities from developing countries require external funds to modernize operations retarded by state-owned budgets. Country risk must be monitored, loan policies must be established, and control systems must be implemented before banks engage in international lending. Countries experiencing transfer problems may be criticized by ICERC and require global banks in the U.S. to increase their allocated transfer risk reserve. Many international loans are related to trade finance, which is described in Lesson 4.