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The Assessment of Country Risk by Australian Banks

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ABSTRACT

This paper attempts to identify standard Australian bank practice in assessing country risk . The paper initially comments on and identifies how international banks assess country risk. Based on a questionnaire, the paper then examines how Australian owned banks assess country risk. Several general observations are also made on how Australian owned banks manage country risk.

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by
Mark A Tucker

Introduction

In the past 25 years or so the risks associated with international bank lending have increased considerably. During this period, the concept of country risk emerged, and with it, the practice of country risk assessment. With the debt servicing crisis of the 1980s together with increased lending competition, the banks need for better methods of assessing country risk intensified.

Country risk is generally defined as the ability and willingness of a country to repay a loan. The ability of a country reflects mainly economic factors, while the willingness reflects political and social factors. Recent economic, political and social events in countries such as Russia, South Africa, Rwanda, Israel, China, Yugoslavia and between North and South Korea represent sources of country risk. Country risk is, therefore, the principal factor that distinguishes international bank lending from domestic lending.

The focus of this paper is to ascertain how Australian banks assess and manage country risk. While much has been written on how international banks assess country risk, very little has been written on how Australian owned banks assess and manage country risk. This paper is divided into four sections. The first section briefly comments on and identifies how international banks assess country risk. The second section discusses the methodology adopted by the author to determine how Australian owned banks assess country risk. The next section examines how Australian owned banks actually assess country risk. Apart from identifying standard Australian practice, the section also makes some general observations about the management of country risk. The final section offers some overall observations about the assessment of country risk by Australian owned banks.

1. Assessment of Country Risk by International Banks

The assessment of country risk usually comprises two components- a country study and a system of measuring the degree of risk based on the creditworthiness of the borrowing country. There is however, no "correct" nor standard approach used by banks when assessing country risk. The approach used by a bank largely reflects the nature and magnitude of its international operations and its organisational structure. A bank with an extensive international exposure is likely to have its own economics department which has developed its own method of assessing and measuring country risk. On the other hand, a smaller bank with limited international exposure is more likely to rely on external analysis provided by a specialist agency.1

Over the last three decades, international banks have tended to be secretive about how they specifically assess country risk. Nevertheless, during this period a large body of literature has emerged on the more common approaches and techniques used by banks in undertaking a country study. These approaches can be classified into four broad categories, they are:2

(a) Fully Qualitative - This approach has no fixed format and the content of each study will vary from country to country. The assessment process tends to be subjective; because of the lack of uniformity, and it is hard to make country - by - country comparisons.

(b) Structured Qualitative - This approach has a standardised format with some statistical analysis. Again, the approach is largely subjective, yet being standardised, comparisons between countries can be made.

(c) Checklist - This approach involves a set of relevant economic, political and social indicators. These indicators, which can be either weighted or unweighted, are assigned a numerical score. This approach makes it easier to rank and compare countries.

(d) Mainly Quantitative - This approach involves the extensive use of econometric and statistical methodologies. Although the most objective approach, it can be difficult to obtain consistent data and can be time consuming to develop.

Each approach exhibits various advantages and disadvantages. Whatever approach is used by a bank, it should provide the decision makers with a good understanding of the key issues, trends and prospects.

Having determined its approach, the bank also needs to establish a system of risk rating, in order to assess a country's creditworthiness. This risk rating must reflect the overall degree or level of country risk. A variety of risk rating techniques exist. A bank may develop its own system of risk rating or use the services of an independent risk rating agency. The main risk measurement techniques used by banks are:

(a) A numerical score, for example ranging from 1 to 10 or a mark out of 100,

(b) A series of letter grades, for example ranging from A (best) to F (worst),

(c) A series of descriptive forms, for example high risk, medium risk and poor risk,

(d) Consensus determined by a Department/Committee meeting - resulting in a grading schedule,

(e) Use the risk rating system given by a leading banking/financial magazine,

(f) Explicitly weight various factors/indicators - resulting in a grading schedule, and

(g) A matrix - resulting in a grading schedule.

While the main focus of this paper is on how Australian - owned banks assess country risk, it is useful to briefly identify how foreign international banks assess country risk. A discussion on the approaches used by selected foreign international banks to assess country risk can be found in Ensor(1981), Miklos(1983), Nagy(1984), Mayer(1985) and Swiss Bank Corporation(1988). However these sources relate to approaches in use during the late 1970s and 1980s. Since then, the effects of the recession may have forced banks to revise their method of assessment.

To ascertain how foreign international banks currently assess country risk the author randomly surveyed 21 of these banks operating in Australia during December 1993. Only 13 of these banks responded to the survey and the results are shown in Table 1. Although a small representative sample, it covers banks in North America (3), Europe (7), and Asia (3). The Table shows the methodology and the risk measurement techniques currently used by 13 foreign international banks.

Table 1 indicates that most foreign international banks use a structured qualitative approach, which is sometimes supported by a checklist, when undertaking a country study. The two most popular risk rating techniques were consensus determined by a department/committee meeting and a numerical score; both techniques result in a grading schedule. Not surprisingly, foreign international banks have no standard method of assessing country risk. Each bank uses the method that best suits its needs, relative to its level of international exposure and organisational structure. Having gained an insight into how several foreign international banks assess country risk, let us now briefly examine the approach used to identify how Australian - owned banks assess country risk.

TABLE 1
COUNTRY RISK METHODOLOGY

BANK	COUNTRY STUDY APPROACH	RISK MEASUREMENT
Asia:		
Bank of Singapore	Structured Qualitative supported by Checklist	Department Consensus
Bank of Tokyo	Checklist	Explicitly weight factors
Hong Kong Bank	Structured Qualitative	Matrix
Europe:		
Banque National De Paris	Checklist	Department Consensus
Barclay's Bank	Structured Qualitative	Numerical Score
Credit Lyonnaise	Quantitative	Numerical Score
Credit Suisse	Structured Qualitative supported by Checklist	Department Consensus
National Westminster	Quantitative	Explicitly weight factors
Societe Generale	Checklist	Matrix
Swiss Bank Corporation	Structured Qualitative	Department Consensus
North America:		
Bankers Trust	Fully Qualitative	Explicitly weight factors
Canadian Imperial Bank of Commerce	Structured Qualitative	Numerical Score
Chase Manhattan Bank	Quantitative and Checklist	Numerical Score

2. The Methodology of Assessing Country Risk by Australian - Owned Banks

To the author's knowledge, nothing has been written publicly on the methodology used by Australian owned banks to assess country risk. To remedy this deficiency, the four major Australian - owned banks were asked to complete a questionnaire to ascertain Australian banks' practices in assessing country risk.

The questionnaire was distributed to the four major Australian - owned banks between December 1993 and March 1994. The questionnaire, totalling 18 questions, sought to ascertain the views of country risk analysts on assessing country risk. While many of the questions were devised by the author, others were based (and adapted in part) on a similar survey undertaken by the Group of Thirty (1982). While all four Australian - owned banks responded to the questionnaire, not all questions were answered. Nevertheless, a general trend on methodology was still discernible. Finally, it should be noted that all respondents were promised absolute confidentiality.

A possible drawback of this survey is that some respondents may not have divulged what they actually do, while other respondents may give answers that would put their organisation in a favourable light. However, the sample was undertaken independently, with none of the banks knowing or seeing the responses of their competitors - at least to the author's knowledge. Nevertheless, the results of the survey do provide a useful insight into standard Australian practice in assessing country risk.

3. Survey Results

The majority of Australian - owned banks began to assess country risk in the mid to late 1970s. A period characterised by the OPEC oil price rise, the revolution in Iran and the invasion of Afghanistan. It is also worth noting that several state government owned banks also became actively involved in assessing country risk during the 1980s.

In each bank, the Economics Department was responsible for preparing country risk studies. The number of studies undertaken was largely based on the bank's level of international exposure. Most banks tended to complete between 20 to 40 country risk studies a year. These were prepared by one or two staff members at each bank.

Most banks have developed an "in house" structured qualitative approach towards undertaking a country study: that is, they use a standard format with some statistical analysis. The average length of a country study, for most banks, was four to six pages. The majority of banks covered a mix of countries from different geographic regions. Only one bank concentrated its country risk analysis on a particular region. Furthermore, most banks' offshore offices/branches did not undertake nor participate in the assessment of country risk in their region.

The majority of banks considered publications by the Institute of International Finance (IIF) - such as their Country Report, the International Monetary Fund (IMF) - particularly their International Financial Statistics, reports by inter - government organisations - such as the World Bank, and reports from consultants or external assessments - such as EIU Country Reports as the most important sources of information in assessing country risk. Reports by bank staff in or visiting a country, newspaper and magazine articles and discussions with clients indigenous to the country were considered moderately important sources of information.

Analysis of political, social, economic and debt factors had the greatest weight in assessing country risk. The majority of banks did not conduct their own questionnaires nor undertake econometric modelling in assessing country risk. Given the increasing importance and variety of computer based quantitative programs available, it is somewhat surprising that most banks continue to emphasise a qualitative approach in assessing country risk.

The main economic/financial statistics considered by the banks in assessing country risk were GDP growth, the government budget deficit/surplus,industry structure/concentration, the inflation rate, the money supply, the balance of payments position - especially the current account, the level of international reserves and import cover.

The main political/social factors considered were the strength of the countries political structure, the level of government intervention in the business sector, the government's economic policy philosophy, the nature of social cohesiveness - especially in terms of minority groups and racial or religious differences, and foreign relations within the region and internationally. The principle debt factors considered were Debt/GDP, Debt/Exports, the debt service ratio, the term structure of debt and the level and nature of aid donations.

All banks incorporated three years of historical statistical data, while the majority of banks provided two year forecasts on selected economic and financial variables, when assessing country risk.

In determining a country's overall level of risk, various methods were used by Australian owned banks. The most popular method was consensus determined by a department/committee discussion resulting in a grading schedule.

All banks reviewed their country risk reports annually. The majority of banks had their country limits established by a Credit Committee which would report to the Bank's Board. The main factors taken into account, by all the banks, when determining a country's exposure limit were the country risk evaluation results, geographic balance, marketing strategy, and the bank's historical relationship with the borrower.

While the questionnaire has highlighted trends in methodology, four additional observations can be made about the assessment and management of country risk by Australian - owned banks.

First, during the 1980s, all four Australian - owned banks were members of the Institute of International Finance (IIF). Since then however, membership has declined. The IIF, established in 1983, serves as a forum for international banks involved in cross-border lending and as a source of information. The IIF provides country risk analysts with confidential country reports, surveys on debt restructuring by banks, rescheduling details and examines a variety of current issues that affect international bank lending.

Secondly, since 1984 country risk analysts representing Australian - owned banks have met fairly regularly to discuss issues relating to the assessment of country risk. These meetings provide an informal basis for analysts to meet and discuss such issues as country risk methodology, sources of information and examine pertinent regional/world issues.

Thirdly, most of the Australian - owned banks have contributed to surveys undertaken by financial magazines such as <u>Institutional Investor</u> and <u>Euromoney</u> - on country credit/risk ratings. These surveys ask bankers around the world to evaluate the creditworthiness/risk of the countries to which they lend.

The <u>Institutional Investor</u> country credit rating is published twice a year. According to <u>Institutional Investor</u>:

> "Bankers are asked to grade each of the countries on a scale of zero to 100, with 100 representing those with the least chance of default. ... The individual responses are weighted using a Institutional Investor formula that gives more importance to responses from banks with greater worldwide exposure and more sophisticated country analysis systems."3

The <u>Euromoney</u> country risk rating is published annually and is based on the performance of a country in the financial markets. The <u>Euromoney</u> country risk method:

> "... uses nine categories which encompass three broad categories (analytical indicators, debt indicators, and access to international finance). Euromoney's September 1993 ranking incorporates a change in our weighting system, giving greater weight to the economic performance and political risk categories, and less weight to categories rating access to international borrowing."4

According to Sampson(1988) these league tables of the world's nations by Institutional Investor and Euromoney exert their "...own power and prestige."5 Sampson claims:

> "These bare ratings may not be very accurate guides to political stability; but they matter to ministers of finance who have to argue with bankers about that extra one-eighth per cent on a billion-dollar loan, and those prestige and machismo is bound up with their place in the list."6

Fourthly, Australian - owned banks have a diversified exposure to borrowers in rescheduling countries. Furthermore, exposure by Australian - owned banks to third world debt is relatively low when compared to other western banks. For example, the 1992 National Australia Bank Limited Annual Report claims that:

> "As a result of the Group's stringent commercial and country risk assessment procedures, and the sale in 1988 of the remaining loans to rescheduling countries, the Group currently has no significant rescheduling country debt."7

In relation to its exposure to debt rescheduling countries, the 1993 Annual Report of the Australia and New Zealand Banking Group Limited claims:

> "The decrease in total exposure reflects the sale of African and Jordanian debt, conversion of Argentine and Philippine debt to US collateralised bonds and the writedown of Brazilian debt, which were partially offset by the inclusion of Iranian debt and exchange rate movements.
>
> During the year no charge (1992:nil) was made to the profit and loss account for provisions against loans to rescheduling countries. Provisions are held amounting to 68.2% (1992: 63.9%) of total exposure. Net exposure continues to approximate secondary market values."8

Similarly, the Westpac Banking Corporation's 1989 Annual Report claims:

> "During the year, steps were taken to reduce the Group's exposure to countries rescheduling external debt from US$244 million to US$73 million as at 30 September 1989, 1.06 per cent of its consolidated capital base. This figure included US$21 million (1988 US$8 million) which is not subject to rescheduling. The previous level of special provisioning was sufficient to cater for this reduction and to establish specific provisions in terms of the Bank of England guidelines for the remaining asset in this category which we propose to retain to maturity."9

4. Conclusion

The assessment of country risk is a difficult task requiring reliable and up-to-date information on a range of volatile variables. The degree of access to information will cause the perception of risk to differ between banks. While the methodology used by Australian - owned banks is similar to international foreign banks, there is no universal standard approach in assessing country risk.

It would seem that standard Australian bank practice in the assessment of country risk involves a structured qualitative approach; prepared independently of the International Lending department. The level of overall risk is determined primarily by department/committee consensus, resulting in a grading schedule. These findings are similar to those in the random survey of international foreign banks in Section 1. Australian banks also incorporate three years of historical statistical data and a two year forecast of selected economic/debt data.

According to claims made in their respective Annual Reports, it would appear that Australian banks have been able to develop and maintain a competent methodology for assessing country risk. The lessons from the past two decades, together with membership of the Institute of International Finance, and the use of technology to quickly access a wide range of information, will allow analysts to play a more effective role in both the management of country risk and the banks' lending policy.

ENDNOTES

1. For a discussion on the various specialist agencies see Bascomb (1993a p.369)
2. Based on the classification used by Goodman (1977)
3. Shapiro (1993 p.179)
4. Bascomb (1993 p.363)
5. Sampson (1988 p.21)
6. ibid
7. National Australia Bank (1992 p.30)
8. Australia and New Zealand Banking Group (1993 p.57)
9. Westpac Banking Corporation (1989 p.13)

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