Although a branch relies on the financial and managerial support of the FBO as a whole, the evaluation of asset quality in a branch is important in assessing the effectiveness of credit and transfer risk management[1] and in the event of a possible liquidation of a branch.

In evaluating asset quality, the examiner will assess the branch's assets and off-balance sheet exposure as of the examination date. These would include, but not be limited to: placements, investments, loans, bankers acceptances, standby letters of credit, and loan commitments. The assessment will take into consideration (1) the level, distribution, and severity of exposure classified for credit and transfer risk, specially mentioned, or listed as Other Transfer Risk Problems, and (2) the level and composition of nonperforming and reduced rate assets.

If the FBO is in less than satisfactory condition and the branch is in a net due from affiliate position, the asset quality rating may be negatively affected.

Additional procedures for evaluating assets and off- balance sheet exposure can be found in the Risk Management section of this manual. This section of the manual discusses the classification of assets and off-balance sheet exposure.

1. While credit and transfer risk are identified as part of the evaluation of asset quality, the effectiveness of the branch's credit and transfer risk management are evaluated under risk management.

According to the methodology established by their respective state or federal agency, examiners will select a sample of assets and off-balance sheet exposures (contingencies) to review in order to evaluate the credit risk exposure to the branch. The credit review includes analyzing individual credits and documenting the findings, discussing the findings with branch management, and assigning asset quality ratings to each credit based on the examiner's best judgment concerning the degree of risk inherent in the credits and the likelihood of an orderly repayment. The credit review also allows for the evaluation of the branch's internal risk rating/grading process.

This section discusses criteria used to assign asset quality ratings to extensions of credit that exhibit potential problems or well-defined weaknesses. These criteria are primarily based upon the degree of risk and likelihood of orderly repayment. Extensions of credit that exhibit potential weaknesses are categorized as special mention, while those that exhibit well-defined weaknesses and a distinct possibility of loss are categorized as classified. The term classified is subdivided into more specific subcategories ranging from least to most severe: substandard, doubtful, and loss. The weighted classified assets and contingencies ratio represents weighted classifications as a percentage of total claims on nonrelated parties plus classified contingencies, and is the standard measure of the overall asset quality (''A'' ROCA component) of the branch.

In reviewing asset quality, examiners identify the amount and severity of credit and transfer risk exposures at the branch. This section discusses credit risk and provides guidelines for the classification of the FBO's loan portfolio and credit substitutes. The more severe classification, whether due to transfer risk or credit risk, takes precedence over the less severe classification. For additional guidelines on the classification of due from banks, placements, securities, other real estate owned and other assets, see those sections of this manual. For guidelines on transfer risk classification refer to the Transfer Risk section of this manual. The following section provides guidelines for the classification of the FBO's loan portfolio and credit substitutes.

ASSESSMENT OF CREDIT QUALITY

The evaluation of each extension of credit should be based upon the fundamental characteristics affecting the timely collectibility of that particular credit, including at a minimum:

- The original source of repayment and the borrower's continuing ability to utilize that source;
- The purpose of the credit relative to its source of repayment;
- The underwriting of the credit relative to its purpose, terms and structure;
- The overall financial condition and resources of the borrower, including the current and stabilized cash flow, debt service capacity, and future prospects;
- The credit history of the borrower; and,
- The types of secondary and tertiary sources of repayment available, such as guarantor support and the collateral's value and cash flow. (The undue reliance on secondary sources of repayment should be questioned, and the branch's policy about permitting such a practice should be reviewed.)

The longer the borrower has the branch's funds or a contractual right to obtain funds, the greater the risk of some adverse development in the borrower's ability to repay the funds. Confidence in the borrower's repayment ability is usually based upon past financial performance and projections of future performance. Failure to meet projections is a credit weakness but does not necessarily mean the asset should be criticized or classified. On the other hand, the inability to generate sufficient cash flow to service the debt is a well-defined weakness that jeopardizes the repayment of the debt and, in most cases, merits classification. The extent and nature of a shortfall in the operating figures, the support afforded by assigned collateral, and/or that provided by cosigners, endorsers, or guarantors, should influence the severity of the classification.

Specially Mentioned Category

A specially mentioned extension of credit has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the credit or in the branch's credit position *at some future date*. Specially mentioned credits are not adversely classified and do not expose a branch to sufficient risk to warrant adverse classification. However, because specially mentioned credits can be indicative of emerging credit problems, examiners are to consider the level and trend of these credits in their analysis of the branch's assets and off-balance-sheet items.

Extensions of credit that might be detailed in this category include those where:

- Lending officers may be unable to properly supervise the credit because of an inadequate loan or credit agreement;
- Questions exist regarding the condition of and/or control over collateral;
- Economic or market conditions may unfavorably affect the obligor in the future;
- Obligor's operations may show a declining trend or an imbalanced position in the balance sheet, but not to the point that repayment is jeopardized; or
- Deviations from other prudent lending practices are present.

The Special Mention category is not to be used to identify a credit that has as its sole weakness credit data or documentation exceptions that are not material to the repayment of the asset. It is also inappropriate to use this category to list credits that bear risks usually associated with a particular type of financing. Any type of credit, regardless of collateral, financial stability, and responsibility of the obligor, involves certain risks. For example, a loan secured by accounts receivable has a certain risk, but the risk must have increased beyond that which existed at origination to categorize the credit as special mention. A rapid increase in receivables for reasons that are unknown to the branch, concentrations that lack proper credit support, lack of on-site audits, or other similar matters could lead the examiner to question the quality of the receivables and possibly special mention the loan.

When classifying a credit, it may not be appropriate to list the entire amount under one credit quality category. This situation is commonly referred to as a ''split classification'' and may be appropriate in certain instances, especially when there is more certainty regarding the collectibility of one portion of the credit than another.

Extensions of credit that exhibit well-defined credit weaknesses may warrant classification based on the description of the following three classification categories:

Substandard—A substandard credit is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Credits so classified must have a well-defined weakness or weaknesses that jeopardize the repayment of the debt. They are characterized by the distinct possibility that the branch will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual credits classified substandard.

Doubtful—A credit classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or repayment in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high but because of certain important and reasonably specific pending factors, which may work to the advantage and strengthening of the credit, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include proposed merger, acquisition, or liquidation procedures; capital injection; perfecting liens on additional collateral; and refinancing plans.

Examiners should avoid classifying an entire credit doubtful when collection of a specific portion seems highly probable. An example of proper utilization of the doubtful category is the case of a company being liquidated, where the trustee-in-bankruptcy has indicated a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the branch. In that situation, estimates are based on liquidation value appraisals, with asset values yet to be realized. By definition, the only portion of the credit that is doubtful is the 25 percent difference between 40 and 65 percent. A proper classification of such a credit would show 40 percent substandard, 25 percent doubtful and 35 percent loss.

Examiners should avoid repeating a doubtful classification at subsequent examinations. The time between examinations should be sufficient to resolve pending factors. That is not to say that situations do not occur to necessitate continuation of the doubtful classification. However, the examiner should avoid undue continuation if repeatedly, over the course of time, pending events do not occur and repayment is again deferred awaiting new developments.

Loss—Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Writing off a loss asset or the portion of an asset identified as loss ensures that the value of the branch's assets are properly reflected on its Report of Assets and Liabilities. A loss asset should not remain on the branch's books while it attempts a long-term recovery. Rather, losses should be taken in the period in which they surface as being uncollectible.

Branch management should maintain a record of all loss assets or the portion of assets identified as loss that have been written off for regulatory reporting purposes or for which a specific reserve has been established. Branch records should also demonstrate that these loss assets have been fully reported to the head office. For further information on the treatment of loss assets, examiners should refer to their respective agency's policy.

Partially Charged-Off Loans

Based upon consideration of all relevant factors, an evaluation may indicate that a credit has well-defined weaknesses that jeopardize collection in full but that a portion of the loan may be reasonably certain of collection. When an institution has taken a charge-off or a specific reserve in an amount that is sufficient, so that the remaining recorded balance of the loan (a) is being serviced (based upon reliable sources) and (b) is reasonably certain of collection, classification of the remaining recorded balance may not be appropriate. For example, when the remaining recorded balance of an asset is secured by readily marketable collateral, the portion that is secured by this collateral would generally not be classified. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than substandard.

A more severe classification than substandard for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, e.g., where significant risk exposures are perceived, such as might be the case for bankruptcy situations or for loans collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

Formally Restructured Loans

For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate, if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified terms. The classification treatment previously discussed for a partially charged-off loan also would generally be appropriate for a formally restructured loan, when partial charge-offs have been taken. Troubled loans, whose terms have been restructured, should be identified in the branch's internal credit review system and closely monitored by management. Risk management of the branch should not be criticized for continuing to carry loans having weaknesses that result in classification as long as the management has a well-conceived and effective workout plan for such borrowers and effective internal controls to manage the level of these loans. This principle holds for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties.

The Role of Guarantees

The original source of repayment and the borrower's intent and ability to fulfill the obligation without reliance on third party guarantors will be the primary basis for the review and classification of assets. However, examiners may also consider the support provided by guarantees. The presence of a guarantee from a ‘‘financially responsible guarantor’’ may be sufficient to preclude or reduce the severity of classification. For purposes of this discussion, a guarantee from a ‘‘financially responsible guarantor’’ has the following attributes:

- The guarantor must have both the financial capacity and willingness to provide support for the credit;
- The nature of the guarantee is such that it can provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term; and,
- The guarantee is legally enforceable.

These attributes are discussed in more depth below.

Financial Capacity of Guarantor—The branch must have sufficient information concerning the guarantor’s financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor’s financial capacity to fulfill the obligation. In addition, it is important to consider the number and amount of guarantees currently extended by a guarantor in order to determine that the guarantor has the financial capacity to fulfill all of the contingent claims that exist.

Guarantor’s Willingness to Repay—Examiners normally rely on the analysis of the guarantor’s financial strength and assume a willingness to perform unless there is evidence to the contrary. Examiners give due consideration to those guarantors that have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees on similar facilities. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. Examiners do not give credence to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee obligation under review. Examiners also consider the economic incentives for performance from guarantors. This includes guarantors who have already partially performed under the guarantee, who have other significant investments in the project, whose other sound projects are cross-collateralized or otherwise intertwined with the credit, or whose guarantee is collateralized by readily marketable assets that are under the control of a third party.

In general, only guarantees that are legally enforceable will be relied upon. However, all legally enforceable guarantees may not be acceptable. In addition to the guarantor’s financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection or undue complexities or uncertainties about the guarantee.

The nature of the guarantee is also considered by examiners. For example, some guarantees for real estate projects only pertain to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases.

Examiners should also consider the branch’s intent to enforce the guarantee and whether there are valid reasons to preclude it from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of guarantees will be a positive consideration in the classification process.

Guarantees issued by the head office of the branch for credits on the books of the branch lend no additional support to credits. The branch and its head office are one legal entity. Guarantees from affiliates of the foreign banking organization may offer some additional support if the affiliate is a separate legal entity. However, adequate financial information must be available to support financial capacity. Nevertheless, such affiliate guarantees do not stand entirely alone and do not offer the kind of support similar to that of a third party guarantee.

Off-Balance-Sheet Items

The principal off-balance-sheet credit transactions likely to be encountered during loan reviews are standby letters of credit (SBLCs), and loan commitments. When evaluating off-balance-sheet credit transactions for potential classification or special mention, careful consideration should be given as to whether the branch is irrevocably committed to advance additional funds under the credit agreement. If the branch must continue to fund the commitment and a potential weakness exists that if left uncorrected may at some future date result in the deterioration of repayment prospects or the branch's credit position, the amount of the commitment may be categorized as special mention. If there is a well-defined weakness that jeopardizes repayment of a commitment, classification may be warranted.

For credit analysis purposes, SBLCs should be treated as if they were loans to the account parties. They are considered one *type of* instrument that a customer can use under the overall credit line that has been extended by the branch. In most cases, particularly with respect to credit enhancement-type SBLCs, the examiner will classify the SBLC if it is determined that the account party will need to draw on the SBLC. In such cases, the account party, having been financially unable to meet its underlying commitment, probably may not be able to reimburse the branch for making payment on the SBLC. The same holds true for commitments to issue SBLCs. If the branch has an unrevocable commitment to issue a SBLC and it is determined that the account party will need to draw on the SBLC, examiners will classify the commitment.

In the case of loan commitments, credit risk stems from the possibility that the creditworthiness of the customer will deteriorate between the time the commitment is made and the funds are advanced.

Refer to the Off-Balance Sheet-Activities and Letters of Credit sections of this manual for additional information on off-balance-sheet items.

Guidelines for Special Mention and Classified Credit Comments

An examiner must present, in written form, well-supported comments relating to assets and contingencies subject to classification or special mention. Write-ups are mandatory when branch management disagrees with the examiner's assessment. Examiners should consult with their respective agency for guidance on when other write-ups are required. A thorough understanding of all factors surrounding the credit is required, so that only those germane to the credit's collectibility are included. When portions of the line are assigned different classifications or are not classified, the comments should clearly set forth the reason for such split treatment.

Before a write-up is prepared, the examiner should recheck central liability files or other sources at the branch to determine that all credits to the borrower have been noted and included. Consideration should be given to the classification of accrued interest receivable. Classification is suggested when the cumulative effect on classified percentages is significant or the accrued interest is appropriately classified loss. (See the Credit Risk Management section of this manual for a discussion of nonaccrual status and the reversal of accrued interest for loans when nonaccrual status is appropriate).

When financial institutions engage in international lending, they undertake customary credit risk, or the possibility of nonpayment due to an obligor's weak financial condition or a lack of adequate collateral protection. International lending also leads to country risk, which encompasses the entire spectrum of risks arising from the economic, political, and social trends and movements in a foreign borrower's home country.

International lenders, in particular, bear the risk that a foreign borrower will be unable to convert its local currency income into the currency needed to repay the loan (i.e., transfer risk). Transfer risk therefore, focuses on a borrower's capacity to obtain the foreign exchange required to service its cross-border debt. Because branches are typically oriented toward financing international trade and business, transfer risk can be a significant consideration in evaluating a branch, more so than at other types of financial institutions. Irrespective of its significance, the criteria and guidelines for evaluating transfer risk exposures at branches are similar to those at other U.S. financial institutions.

TRANSFER RISK CRITERIA

In 1979, the federal regulatory agencies adopted uniform examination procedures for evaluating and commenting on country risk factors resulting from international lending by banks in the United States. Under this system, examiners segregate country risk factors from the evaluation of other lending risks. In December 1983, the federal banking agencies, through the Interagency Country Exposure Review Committee (ICERC), further adopted examination categories for identifying credits that have been adversely affected by transfer risk problems. These categories include classified credits, i.e., Substandard, Value Impaired, and Loss; Other Transfer Risk Problems (OTRP); and Exposures Warranting Special Comment (EWSC). The examination of transfer risk entails identifying and reporting transfer risk credits according to these categories. To maintain uniformity of examination approach, examiners are not free to deviate from these guidelines or assign transfer risk designations other than as specified by ICERC.

The criteria for these transfer risk categories are as follows:

Substandard

Either, the country is not complying with its external service obligations as evidenced by arrearages, forced restructuring, or rollovers and, the country is not in the process of adopting an IMF or other suitable economic adjustment program or is not adequately adhering to such a program; or the country and its bank creditors have not negotiated a viable rescheduling and are unlikely to do so in the near future.

Value Impaired

The country has protracted arrearages as indicated by more than one of the following:

- The country has not fully paid its interest for six months;
- The country has not complied with IMF programs (and there is no immediate prospect for compliance);
- The country has not met rescheduling terms for over one year; and
- The country shows no definite prospects for an orderly restoration of debt service in the near future.

Loss

A loss classification applies when the credit is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. An example of such an asset is a loan to a country that has made an outright statement repudiating obligations to banks, the IMF, or other lenders.

Other Transfer Risk Problems (OTRP)

The OTRP designation is used to highlight all or a portion of those credits to:

- A country that is not complying with its external debt service obligations but is taking

positive steps to restore debt service through economic adjustment measures, generally as part of an IMF program;
- A country that is meeting debt obligations but noncompliance seems imminent; or
- A country that has been classified previously, but recent debt service performance indicates classification is no longer warranted. However, sustained resumption of orderly debt service needs to be demonstrated.

Exposures Warranting Special Comment

EWSC categorizations are Strong, Moderately Strong, and Weak. A Strong country does not experience social, economic, or political problems that could interrupt external debt repayment. Moderately Strong countries experience a limited number of identifiable economic, social, or political problems that do not presently threaten orderly external debt repayment. A Weak country experiences many economic, social, or political problems. If not reversed, these problems could threaten orderly external debt repayment.

Other Definitions

The ICERC committee generally accords a more favorable examination treatment to performing trade credits and performing bank credits. In this context, *performing* generally means that the credit is paying down in accordance with the existing terms of the indebtedness.

Trade transactions generally include the short-term financing of the importation or exportation of goods/services between parties in two countries.

So called pre-export financing transactions require close review as they may in fact be working capital advances. There must be a connection between the branch's financing and the import or export of goods (self-liquidating transactions) to be considered as a trade transaction.

Performing bank generally includes all extensions of credit to banks which are current.

Short-term loans generally have a maturity of one year or less.

Long-term loans exceed one year in tenor.

In assessing exposure by country, adjustments to determine net exposure are made for guarantees and collateral. Risk is transferred from the country of borrower's domicile to the country the guarantor or collateral resides or is held.

Guarantees consist of those claims of the reporting institution to which a third party or affiliate formally and legally obligates itself to repay the reporting institution's claims on the direct obligor if the latter fails to do so. Documents such as comfort letters, letters of awareness, or letters of intent that do not establish firm legal obligations are not considered guarantees for the purpose of transferring country risk. Guarantees cover the collateralization of claims if the collateral or the guarantors' source of funds is both (1) tangible and liquid including readily marketable shares of stocks or bonds and (2) is held and realizable outside of the country of the domicile of the borrower. In cases involving collateral, the domocile of the guaranteeing party is the country in which the collateral is held, unless the collateral is stocks or bonds in which case it is the country of domicile of the party issuing the security.

1. To evaluate the branch's country exposure risk management system. To determine if the branch's policies, practices, procedures and internal controls regarding the management of transfer risk are adequate.
2. To determine if the branch is operating in conformance with established guidelines.
3. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulation have been noted.
4. To evaluate the branch's portfolio in order to determine the appropriate ICERC treatment ranging from loss to strong.
5. To determine the effect of total transfer risk classifications and OTRP listings on overall asset quality.
6. To determine the accuracy of the branch's transfer risk exposure reporting to senior branch and head office management.
7. To determine if the branch is properly preparing the Country Exposure Report (FFIEC 019), which is required to be filed quarterly with its district Reserve Bank.

In reviewing asset quality, examiners identify the amount and severity of transfer risk exposures at the branch. Examiners should begin this review by first evaluating all transfer risk credits for credit risk. The more severe classification, whether due to transfer risk or credit risk, takes precedence over the less severe classification. If the classifications are the same, the credit risk designation takes precedence over the transfer risk designation. Duplications should be avoided.

In some instances, particularly where additional collateral has been pledged, the focus of the risk may change and the transfer risk classifications may not be appropriate. Classifications may also differ based on the type of exposure, e.g., performing bank and trade credits are generally less severely categorized than short- and/or long-term loans.

Information concerning the relative grouping and classification of countries and appropriate comments prepared by ICERC is furnished to examiners as required in the examination process. In turn, examiners should discuss with branch management only those ICERC designations for which the branch has actual exposure on its books. Because this information is sensitive in nature, adequate safeguards should be taken to ensure that it is not accessible to unauthorized personnel. In no event should the complete listing of ICERC designations be divulged.

As mentioned earlier, transfer risk categorizations should be strictly followed; examiners may not deviate from the transfer risk assessments as designated by ICERC. For exposures to countries that are not reviewed by ICERC,[1] examiners should evaluate the exposures from a credit risk standpoint only. In no instance should the examiner assign transfer risk assessments for countries not rated by ICERC or use the prior rating of a country before it was dropped from review by ICERC.

CONTINGENT LIABILITIES

In view of the variance in risk of different off-balance-sheet instruments, contingent liability claims on countries, which are treated as Value Impaired, Substandard, or OTRP, should be reviewed on a case-by-case basis. Because the likelihood of funding even legally-binding agreements is greatly diminished, the exposure is listed but not classified. As a result, except when determined with reasonable certainty that an indirect exposure will require funding, these items generally will be treated as OTRP. However, for those countries considered Loss for transfer risk purposes, performing bank and performing trade credits should be classified as Substandard.

PLACEMENT AND DISCUSSION IN THE EXAMINATION REPORT

In the examination report, transfer risk exposures are reported and discussed separately from commercial credit risk exposures. For this purpose, separate report pages, i.e., Transfer Risk and Items Subject to Classification and Items Listed for Special Mention, have been created for credits subject to classification or comment. The Transfer Risk page should contain a listing, by country, of exposures subject to classification as a result of transfer risk considerations and of exposures listed as OTRP.[2] For each country, examiners should provide commentary on each exposure classified for transfer risk or listed as OTRP. The examiner's commentary should be followed by the supporting write-ups prepared by ICERC on each country.

After identifying the amount and severity of transfer risk exposure(s) at the branch, this information is summarized on the Comparative Asset Quality Data examination report page (along with any credit risk classifications) and discussed on the Asset Quality page. In those

1. Countries are selected for review by ICERC based on the amount of total exposure outstanding to U.S. financial institutions.

2. While not subject to classification, significant OTRP exposures should be considered by examiners as a judgmental factor in their general assessment of a branch's asset quality. This approach is similar to the consideration given to such factors as concentrations in the portfolio, including, for example, the level and composition of nonaccruing or reduced rate assets and concentrations to countries rated as EWSC. In this regard, exposures categorized as EWSC, if material, can be mentioned in the report or listed on the Concentrations page.

instances where the branch has other exposures of concern, which warrant special attention by branch and head office management, comments in this respect should be included on the Asset Quality page. As discussed in the ROCA rating system, any comments relating to how the branch manages its transfer risk exposure should be discussed on the Risk Management page. Comments along these lines may relate to the effectiveness of the branch's country exposure reporting systems. Transfer risk classifications of any significance should be highlighted on the Examination Conclusions and Comments page.

CONCENTRATIONS

Certain U.S. branches may engage heavily in financing international business and trade from their home countries or geographic regions. As measured in terms of their total net assets, these branches may thus have significant concentrations to those countries or regions, which should be listed on the Concentrations page. However, the degree to which these exposures pose any risk to the branch itself, and thus are commented on in the report of examination, is dependent upon a number of considerations, such as the overall composition of the branch's portfolio; the branch's business plan; the effectiveness of the branch's risk management techniques, including its country risk reporting systems; and the strength-of-support assessment of the foreign banking organization. Whether or not concentrations are worthy of comment, examiners should ensure that all such exposures are within the branch's internal policy limits and are monitored and periodically reported to the head office.

COUNTRY EXPOSURE REPORT (FFIEC 019)

Examiners are encouraged to review the Instructions for Preparing the Country Exposure Report. Examiners are not expected to review the Country Exposure Reports filed between examinations for accuracy; however, examiners should conduct a spot check of the most recent report to verify that the reports are being prepared accurately. Material reporting errors uncovered during the examination should initially be noted on the Compliance page in the report of examination. In those instances where branch and head office management rely on the data generated for the Country Exposure Report and reporting exceptions are noted, comments should be incorporated on the Operational Controls page.

RESERVING REQUIREMENTS

The regulations requiring banking institutions to establish special reserves, i.e., an allocated transfer risk reserve or ATRR, against the risks presented in certain international assets[3] are *not* applicable to branches of FBOs (Regulation K, Section 211.42). However, branches are expected to have policies in place for recognizing loss assets or writing down assets that are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. In many instances, these policies stem from home country regulations that are in place for the FBO as a whole.

Separately, examiners should evaluate the amount of transfer risk inherent in a branch's assets in the same manner as for other banking institutions. If applicable, for assets that are classified Value Impaired, any amount on the books above the required ATRR percentage is weighted at 100 percent; the residual amount is weighted at the same percentage as assets classified Substandard, or 20 percent.

COUNTRY EXPOSURE RISK MANAGEMENT SYSTEM

As part of its overall risk management techniques, branch management should have in place a country exposure risk management system, which has been developed, in conjunction with, and approved by head office management. Examiners should evaluate the effectiveness of the system to monitor and control the branch's country exposure by verifying adherence to country suballocation limits and accurate reporting of country exposures submitted on the FFIEC 019. The evaluation should include a review of the exposures for at least several countries. Material exceptions may be subject to comment on the Risk Management page in the report of examination.

3. Those assets included on the FFIEC 019.

The following procedures should be used by examiners in evaluating systems employed by branches to monitor and control country risk elements in international loan portfolios:

1. Review the branch's written policies covering transfer risk and the name, composition, and location of the committee responsible for administration of transfer risk.
2. Review policies and:
   a. Determine who initiates and who gives final approval of country ratings and country limits.
   b. Determine how frequently, and by whom, country ratings and limits are reviewed and changed.
   c. Determine how the bank defines the ratings assigned to the various countries.
   d. Ascertain how country limits are determined.
   e. Determine who is responsible for monitoring compliance with country limits.
   f. Determine to what extent country limits are viewed as guidelines which may be exceeded.
   g. Determine if the branch has different sublimits for private and public sector credits.
   h. Determine if the head office or a committee periodically reviews country ratings and limits, and evaluates the branch's performance against those standards.
   i. Determine how the system has been changed since the previous examination.
3. Review reports furnished to the head office or appropriate committee to assure that comprehensive and accurate information is being submitted on a timely basis.
4. Determine whether the branch is in compliance with its country exposure limits.

In preparing the risk management analysis examiners should consider factors such as:

- The quality of policies, practices, procedures and controls over the country exposure management area.
- The scope and adequacy of the internal loan review system as it pertains to country exposure.
- Causes of existing problems, if any.
- Commitments from branch management for correction of deficiencies.
- Expectations for continued sound international lending or correction of existing deficiencies.
- The ability of branch management to monitor and control transfer risk.
- The general level of adherence to internal policies, practices, procedures and controls.
- The scope and adequacy of the branch's analysis of country conditions if the branch has responsibility for it.

LDC DEBT

The crisis in the 1980s surrounding third world debt spawned a trading market for Less Developed Country (LDC) debt. The examiner may refer to the Federal Reserve's Trading Activities Manual for further guidance concerning the review of LDC debt trading.

1. Has the head office adopted policies and limits for all non-U.S. on- and off-balance-sheet exposure that:
   a. Establish country exposure limits for all activities?
   b. Establish limits for distribution of assets and off-balance sheet exposure by type and maturity?
   c. Acknowledge concentrations of exposure within countries?
2. Are policies and limits reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are country limits revised in response to substantive changes in economic, political, and social conditions within particular countries?
4. Prior to granting additional advances or commitments, are outstandings checked to appropriate country limits?
5. Are lending officers cognizant of specific country limitations?
6. Are procedures for exceeding country limits clearly defined?
7. Does the scope of the branch's asset quality review ensure that international risk assets outstanding and committed are within the branch's foreign exposure limits?
8. Does the branch have a formal reporting system on country risk?
9. Does the reporting system provide complete risk exposure data readily and in sufficient detail?