Guidance paper for Country Risk Management by virtue of Section 15, paragraph 1 of the State Ordinance on the Supervision of the Credit System (AB 1998 no. 16) (SOSCS) for credit institutions licensed by the Central Bank of Aruba (the Bank).

1. Introduction

The purpose of this policy paper is to provide the credit institutions with guidelines to establish an adequate country risk management policy. As country risk is a specific form of credit risk, the general stipulations of the policy paper on credit risk management are also applicable.

2. Definitions

Country risk is defined as the risk on a consolidated basis of:

1. a foreign public authority failing to meet its obligations (sovereign risk); and/or
2. a foreign public authority placing restrictions on funds transfers from other debtors in its country to foreign creditors (transfer risk); and/ or
3. a significant number of debtors in a single country being unable to meet their obligations owing to a specific cause (collective debtor risk). Examples of such a cause are war, political or social unrest, natural disasters and national policy failures in achieving macro-economic and/or financial stability.

The total country risk exposure consists of the aggregate exposure to counterparties established in a single country. In this context exposure comprises:

a. credit portfolio (including credit facilities);
b. trade portfolio (investments);
c. off-balance-sheet items (e.g. guarantees issued on behalf of foreign clients, reserved but unused credit facilities).

To determine the net country risk exposure amount (which is the basis for provisioning), the following items may be deducted from the gross exposure amount:

- provisions for loan losses;
- guarantees and other securities:
    - assets covered by credit insurance;
    - back to back positions;
    - net positions covered by guarantees and other securities, if both political and transfer risk are adequately covered (e.g. when guarantor or security is established respectively located outside the debtor-country).
- trade financing exposures:
  As long as the payment history of a debtor-country is normal, a credit institution's net position due from trade financing with a maturity ≤ 1 year may be excluded from

the country risk provision calculations. Trade financing exposures with a maturity ≤ 3 years may be excluded provided stable conditions existed in the debtor-country for the past ten years.

3. Monitoring of Country Risk

Each credit institution should monitor on an on-going basis its country risk exposure, and assess whether a country risk provision should be formed against this exposure. A country risk provision should be treated as a specific provision and, thus, be deducted from the respective loans / investments for which a country risk provision is formed.

The Bank recommends that the most recent sovereign debt ratings issued by agencies as Standard & Poor, Moody's and Fitch are used as a basis for determining the country risk provision percentage.