Office of the Comptroller of the Currency
U.S. Department of the Treasury [https://occ.gov/index.html]

OCC BULLETIN 2018-25

Subject: Credit Risk
Date: August 28, 2018

To: Chief Executive Officers of All National Banks, Federal Savings Associations, and Federal Branches and Agencies of Foreign Banks; Department and Division Heads; All Examining Personnel; and Other Interested Parties

Description: Informal or Implied Support From Foreign Governments (Implied Sovereign Support)

Summary

The Office of the Comptroller of the Currency (OCC) is issuing guidance to national banks, federal savings associations, and federal branches and agencies (collectively, banks) regarding the role of informal or implied expressions of support from foreign governments (implied sovereign support) in determining a borrower's obligor and facility credit risk ratings. Because implied sovereign support is not a legally binding guarantee, this guidance reminds banks that such expressions of informal or implied support should be viewed as no more than a mitigating factor when evaluating a borrower's credit risk.[1]

Note for Community Banks

This guidance applies to all OCC-supervised banks that have foreign credit exposures.

Highlights

This bulletin provides guidance on

- obligor and facility credit risk ratings that incorporate implied sovereign support as a mitigating factor.
- the adequacy of bank policies to guide the recognition and application of implied sovereign support.

Background

Appendix E of the "Rating Credit Risk" booklet of the *Comptroller's Handbook* explains that informal or implied guarantees from foreign governments (sovereigns) may mitigate credit risk.[2] Examiners have observed that some banks, especially those with meaningful foreign credit exposures, might consider implied sovereign support in their determination of obligor and facility credit risk ratings.

Implied sovereign support reflects an expectation that an obligor will receive financial assistance from a foreign government if the obligor is unable to meet its financial obligations. Implied sovereign support is not legally binding, so banks should not rely exclusively on this informal commitment when evaluating credit risk and assigning risk ratings. Appendix E of the "Rating Credit Risk" booklet lists a number of factors to consider when assessing implied support.

Risk Ratings That Incorporate Implied Sovereign Support

A bank's analysis of a sovereign's ability to informally support an obligor should be based on an assessment of the sovereign's financial strength and any liquidity or legal constraints that might affect the timeliness of such support. The likelihood of implied sovereign support being realized for an obligor depends on the sovereign's legal and financial obligations, the ownership or control of an obligor, and the sovereign's ability and willingness to support the obligor. Evaluating a sovereign's willingness to provide support, absent a legal obligation to do so, involves analyzing the relationship between the obligor and the sovereign. While consideration may be given to an obligor's importance to the sovereign's local economy (e.g., because the obligor is a large employer, a utility, or a systemically important bank), this does not necessarily demonstrate willingness to provide an obligor with financial support. Typically, a bank's analysis should reference any precedent in which the sovereign supported an obligor and assess whether the precedent would likely apply to the bank's obligor. The bank may also consider whether changes in the political environment, economic conditions, or new legislation could affect the sovereign's ability or willingness to support an obligor.

Additionally, the bank should evaluate whether the potential magnitude of implied support for an obligor could negatively affect a sovereign's creditworthiness or the perception of its creditworthiness in the capital markets. This includes assessing the potential that execution of implied sovereign support might trigger the sovereign's default on direct financial obligations, diminishing the likelihood that the sovereign would provide support to the obligor. The bank could determine whether the sovereign has other contingent liabilities, including implied support to other obligors. Such circumstances could impair the sovereign's willingness and ability to provide support when needed by the obligor. For example, supporting an obligor might adversely affect metrics that affect the sovereign's rating such as its debt-to-gross domestic product ratio and foreign currency reserves. The bank may perform an analysis to determine if there are other material factors for consideration, such as correlation between the credit risk of the sovereign and that of the obligor and to what degree the obligor and sovereign are affected by similar risk factors.

Changes in the Regulatory Risk Rating

After the bank analyzes implied sovereign support, it may determine that the application of implied sovereign support justifies a change in the regulatory risk rating. Such changes should be governed by a policy that adequately defines how implied sovereign support is being applied to determine a final regulatory risk rating and what constitutes sufficient supporting analysis.

Bank Policies on Implied Sovereign Support

A sound, well-designed policy on the application of implied sovereign support in determining a borrower's obligor and facility credit risk ratings would apply to all business units within the bank and incorporate the following elements:

- **Criteria** to define how an obligor or facility's stand-alone risk rating may be changed due to recognition of implied sovereign support.
- **Methods** for determining whether implied sovereign support will be considered in a bank's risk rating decisions, including defined credit approval authority levels for final risk rating determinations. This would include periodic reevaluation of obligor and facility ratings to assess whether implied sovereign support continues to be valid.
- **Appropriate documentation standards** that include a tracking process to promote the consistent and appropriate application of the policy's criteria. This generally would include recording both the initial obligor and facility risk ratings as well as the adjusted risk ratings when changes are due to consideration of implied sovereign support.

Further Information

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Related Link

- "Rating Credit Risk" (PDF)

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[1] This guidance does not address legally binding commitments from foreign governments. For more information, refer to the "Rating Credit Risk" booklet of the *Comptroller's Handbook*. In addition, this guidance does not apply to the risk parameter estimation process in the OCC's Advanced Approaches capital rules. Under the Advanced Approaches, banks should only consider sovereign support that is legally binding. Refer to 12 CFR 3.122(c)(4).

[2] Refer to the "Rating Credit Risk" booklet, appendix E, "Classification of Foreign Assets." Banks may not recognize implied support from the U.S. government. The Basel II Final Rule, published at 72 Fed. Reg. 69,288 (December 7, 2007), and 12 CFR 3.122(c)(4) state that "bank[s'] risk parameter estimation process should not rely on the possibility of U.S. government financial assistance, except for the financial assistance that the U.S. government has a legally binding commitment to provide."