

Revised RE-1: Recovery Planning

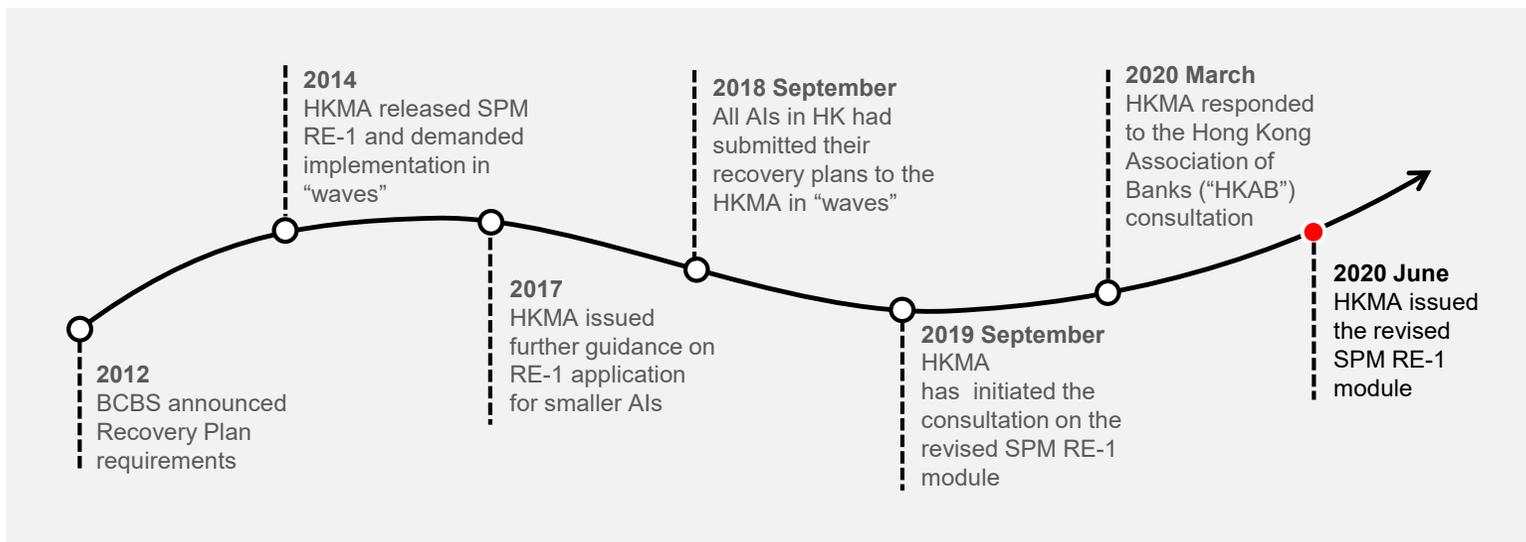
At a glance



What's New?

The Hong Kong Monetary Authority ("HKMA") has issued a revised version of the Supervisory Policy Manual ("SPM") module RE-1 "Recovery Planning" as a statutory guideline under the Banking Ordinance ("BO") on 19 June 2020. The key objectives of this revised version are to incorporate the additional guidance relating to recovery planning set out in the HKMA's circular of 6 July 2017 and to reflect the latest developments in related local and international standards and practices, such as recovery triggers, stress testing and recovery options and eligibility for central bank facilities.

Timeline



Major Updates

Application in Proportionate Manner

While smaller AIs should continue to demonstrate that their Recovery Plans cover all key elements set out in the SPM, a simpler recovery plan with less complex recovery option considerations and communication strategy may suffice.

Latest Developments in Recovery Planning Requirements

Revised SPM has incorporated changes regarding recovery options, triggers, stress-testing and HKMA's liquidity facilities framework.

For more details, please refer to page 2.

Key implications requiring revisions to your recovery plan



Stronger alignment with Group entities needed

AIs are required to take the group entities into their consideration.

These include the reporting of group trigger breaches and consider the impact of the Group's recovery plan on the AI's recovery plan. This will have potential implications on governance & communication protocols.



Higher requirements on quantitative analyses

AIs are required to perform various analyses to further substantiate their understanding and thorough

assessment in recovery planning, such as impact of recovery option through time, near-default scenario testing, etc. AIs will need to enhance calculation tools to help elevate their recovery planning analyses.



More robust considerations in recovery option needed

In addition to capital and liquidity considerations in recovery options, AIs are required to also consider and

identify operational and market challenges such as impediments, access to markets, etc. that are aligned with the conditions set out in specific market-wide or idiosyncratic scenarios. This will require re-assessment of the design of scenarios & recovery options.

Contact us for further discussions

Our team has advised AIs of varying scale and business nature with their recovery planning work against HKMA as well as global guidelines.

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1 Recovery options

[2.3.2] The menu of recovery options... should include options... that measures to secure additional liquidity from existing or new sources while **ensuring sufficient diversification of funding sources...**

[2.3.4] AI should consider an **adequate range of appropriate recovery options** that it may effectively deploy.

Funding sources should be diverse, and consider funding concentration risk across different recovery options. AIs should evaluate whether the breadth of recovery options is adequate to cover different market-wide and/or idiosyncratic crisis situations.

[2.3.8] AIs should...demonstrate certain level of **independent recoverability...**

[2.7.2] Identify... **impediments** to the implementation of individual options (e.g. those arising from interconnectedness within AI or the AI group; and legal, operational, regulatory constraints) , **assess whether and how the impediments identified can be resolved or mitigated**; and assess the **interactions among individual recovery options** and the ability to implement multiple options consecutively in a scenario...

Some AIs have relied heavily, or solely, on Group funding as their core recovery option. The revised guidance calls for more independently executable options by the AIs. This may require identification of local market funding solutions along with detailed and robust documentation of implementation impediments and corresponding mitigations – e.g. down to detailed process flows and timelines with roles & responsibilities assigned.

[2.1.2] A recovery plan should assess the **additional requirements** that may potentially be needed during crisis situations in order to **maintain the AI's membership of, or continued access to, financial market infrastructures**, e.g. potential pre-funding...

Additional financial resources can be in the form of initial margins or prefunded default contributions requirements of a central counterparty. AIs should assess their own business transaction nature to determine the most efficient approach to meet this requirement.

2 Trigger mechanism

[2.4.6] For recovery triggers based on regulatory requirement, the **triggers should be calibrated above the regulatory minima** to ensure that an AI will have sufficient time to take recovery actions before statutory requirements applicable to it.

AIs need to re-calibrate its liquidity and capital recovery triggers to a level that are less severe than the statutory requirements but more severe than the EWIs.

[2.4.5] Some **common examples of triggers** include...rapid decline in profitability and asset quality; increased difficulties in accessing interbank funding market; major compliance incidents or operational issues...

In addition to quantitative triggers, AIs should strengthen their qualitative triggers that are tailored to AIs' structures, businesses and operations. These triggers should consider both market-wide conditions as well as bank specific factors including significant operational incidents.

3 Stress test

[2.6.4] When developing tests that **combined market-wide and idiosyncratic scenarios**, the **inter-relationship between the two should be taken into account**.

Stress testing assumptions under the combined scenario should incorporate interdependencies from market-wide and idiosyncratic scenarios. This will require careful considerations to identify, quantify, and rationalise the inter-relationships.

[2.6.5] AIs are encouraged to adopt more than one scenario within each of the three scenario types... it is acceptable for smaller RE-1 AIs to **test at least one scenario ...under each of the scenarios types**.

AIs in general may require more scenarios to be considered within each of the three types; For smaller RE-1 AIs, some may only have done a single stress test (often for the combined scenario) in the past, in those cases, at least two more stress test scenarios may be needed. Stress assumptions should be different and suitable to individual scenarios.

[2.6.11] Include in the recovery plan a **timeline** of how a scenario evolves, from the occurrence of stress event, breach of specific recovery trigger(s), through to the point where the AI recovers with the deployment of relevant recovery measure or a combination of measures.

The timeline requirement would potentially bring extensive complexity as AIs may have to demonstrate quantitative and qualitative changes & impact on a daily basis (or even on an intra-day frequency level basis for liquidity scenarios). AIs may need to consider automated tools to support quantification and presentation of such information.

4 Reverse stress test

[2.6.8] **Stress scenarios** used for recovery planning purposes should be only "**near-default**", as the aim of recovery planning is to describe options to ensure and restore the financial strength and viability when the AI comes under severe stress.

The importance of reverse stress test is reiterated and AIs may also need to re-run their reverse stress tests with "**near-default**" parameters.

5 Eligibility for Central Bank Facilities

[2.9] An AI could include information... that may facilitate the HKMA's consideration of an application for accessing the **Contingent Term Facility ("CTF")**.

The revised guidance provides an update to the previous Lender of last resort ("LOLR") description with similar information requirements.

6 Consideration of Group Recovery Plan

[1.4.11] AI should...describe whether, and how, the major **recovery options in the group recovery plan**, if deployed, would **impact the local operations** ...

[2.4.4] AIs should **notify the HKMA** promptly of an **actual or likely breach** of a recovery trigger and meet other applicable notification requirements.

The revised SPM calls for much stronger alignment with Group plan, options, governance protocols, etc. In particular for smaller RE-1 AIs or overseas branches, this may involve potentially onerous communication and socialisation effort to obtain additional information and reach agreement on revised governance or communication protocols with parent and inter-group entities.