Growing Asia's Markets

ASIFMA Paper on Potential Enhancement Opportunities to Recovery Planning Guidance

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BACKGROUND

In response to the 2008 Global Financial Crisis, the Financial Stability Board ("FSB") established standards to help improve the recoverability and resolvability of global systemically important financial institutions ("G-SIFIs"). The ultimate goal of these standards is to promote soundness and resiliency within the financial sector and ultimately end the perception of a large financial institution being "too big to fail."

Among a range of other requirements, the FSB expects G-SIFIs to draft and maintain a comprehensive recovery plan. The objective of this plan is to maximise an institution's chances of survival by ensuring that it is prepared to detect, respond to, and recover from severe stress using an arsenal of pre-defined and credible mitigating actions. Following the release of FSB guidance, a number of member jurisdictions – including Australia, Canada, the European Union, Hong Kong, the United Kingdom and the United States – have adopted these standards and require systemically important institutions operating within their respective jurisdictions to maintain comprehensive recovery plans.

The HKMA published its recovery planning requirements as part of the Supervisory Policy Manual module RE-1 ("SPM RE-1") in June 2014. Following recent passage of the Banking (Amendment) Ordinance 2018 by the Legislative Council, the HKMA Banking Policy Department plans to undertake an initiative to review and propose updates to SPM RE-1. To support this work, ASIFMA and its constituent members have compiled a list of potential enhancements to the current requirements which may be appropriate within the SPM or supplementary guidance, depending on their nature. The following enhancement points are based on examination of recovery planning requirements implemented by other jurisdictions along with the experiences of institutions complying with existing expectations regarding their Hong Kong recovery plans.

SCOPE & APPLICABILITY

Consistent with the approach taken by other jurisdictions, the HKMA rolled out recovery planning requirements in three waves for banks:

- The first two waves – expected to establish recovery plans by 2015 and 2016 included the largest locally incorporated authorised institutions ("AIs") that are systemically important to the Hong Kong economy.
- In July 2017, the HKMA released further guidance for a third wave of institutions, including smaller, locally incorporated AIs and foreign bank branches, which were expected to comply with recovery planning requirements by either the end of March or the end of September 2018.

Hong Kong was unusual, if not unique, among global jurisdictions in its requirement that smaller, locally incorporated AIs and foreign bank branches submit recovery plans. The FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions ("Key Attributes") stipulates in paragraph 11.1 that jurisdictions should have in place an ongoing process for recovery and resolution planning, covering at a minimum domestically incorporated firms that could be systemically significant or critical if they fail. Hong Kong's third wave of institutions do not typically provide critical functions and are not systemically significant in the context of the Hong Kong economy and their failures do not pose a threat to the Hong Kong financial system. Further, third-wave institutions include foreign branches that are not domestically incorporated firms. By requiring foreign branches to submit recovery plans, the HKMA's recovery planning goes beyond what is recommended by the FSB and sets Hong Kong apart from other jurisdictions.

Third-wave institutions already possess a range of tools that can be used to mitigate stress. These institutions must adhere to regulatory liquidity limits, including the Liquidity Maintenance Ratio ("LMR"). They must also adhere to a range of liquidity risk management requirements detailed in Supervisory Policy Manual module LM-2 ("SPM LM-2"), such as cash flow projections, liquidity stress testing and contingency funding planning. Though recovery planning is meant to complement these existing stress mitigation tools, there is a large degree of overlap for third-wave institutions, especially given the limited set of credible recovery options available to these types of institutions.

Though the HKMA introduced a welcome degree of proportionality to its recovery planning requirements, ASIFMA and its constituent members feel that more clarity or guidance could be added to SPM RE-1 to ensure that expectations for recovery plans reflect the size and complexity of third-wave institutions, particularly the differences between a locally incorporated firm and a foreign branch. The requirements for larger, locally incorporated AIs are clear and aligned with global leading practices, and therefore this paper will focus on articulating potential enhancement opportunities to the requirements for smaller locally incorporated AIs and foreign bank branches.

Members also request that the Annex to the 6 July 2017 letter setting out guidance on SPM RE-1 be incorporated into the updated SPM RE-1 itself so that AIs may refer to a single document that also takes into account the enhancements suggested in this paper.

GLOBAL PRACTICES

Senior Management Involvement: Global guidance contemplates a significant role for senior management in drafting the recovery plan. The exercise requires an institution make many strategic choices related to recovery options and how they will be implemented during severe stress. It is imperative that the executive accountable work with senior management across a range of functional areas to solicit input and ensure they have a deep understanding of how these options would be executed in practice to maximise the institution's potential for recovery. It has been observed that, for locally incorporated firms, either the CEO, CFO or CRO is responsible for ensuring that the recovery plan receives enough attention from functional areas including Treasury, Risk, Finance, Lines of Business, Strategy, Legal and Compliance. A diverse set of opinions helps to ensure that all potential hurdles and risks are considered when defining and documenting recovery options. Senior management from the head office should ensure that there is broad alignment between the parent company's recovery plan and the local recovery plan. It is also important that senior management from the head office are involved in the drafting stages and understand the nuances of the local recovery plan. Senior management from the head office should ensure that the parent company has the financial and operational capability to meet its obligations. The UK's Prudential Regulatory Authority ("PRA"), in Paragraph 2.91 of Supervisory Statement SS9/17 Recovery planning, has specifically cited expectations to ensure alignment across parent and subsidiary recovery plans, including consistency of recovery options, indicator frameworks and governance arrangements that adequately reflect the interdependencies between the group and subsidiaries.

A distinction needs to be made here, however, between locally incorporated firms and foreign branches. The local organisational structure of a foreign branch is typically a derivative of the global organisation structure commensurate to the size of the local branch's operations. Local management would have oversight of implementing applicable local governance frameworks and systems. Hong Kong has implemented the Manager-in-Charge (MIC) and the Management Accountability regime by the Securities and Futures Commission (SFC) and the HKMA respectively. For foreign branches, therefore, we are of the view that senior management involvement in the Hong Kong recovery plan should be the senior managers identified under the MIC or Management Accountability regime.

Recommendation: Provide more guidance and flexibility in favour of branches on the determination of what constitutes a suitable senior individual to be accountable for the recovery plan in Hong Kong so that different approaches to the Hong Kong recovery plan can be taken by different AIs, as appropriate. For instance, some institutions may have branch-level senior management that can suffice as a point of contact for the HKMA and as the individual responsible for delivering a recovery plan, while other AIs may choose to use an individual at the group level depending on the expertise, governance structure and organisation of the particular AI in question. Additionally, provide clarification on when operations become significant enough for the governance body at the head office to be involved in the review and approval of the recovery plan, the level of involvement and how alignment between the parent company plan and the local recovery plan can be demonstrated.

Board Approval: SPM RE-1 stipulates that, where appropriate, the board of directors is responsible for ultimately overseeing the recovery planning process and has final approval authority. The board of directors is expected to approve an institution's recovery plan upon inception, on an annual basis thereafter, and when there are material changes to the recovery plan or to the institution's operations. The applicability and effectiveness of this requirement depends on the nature, size and entity structure of the particular institution.

Larger, locally incorporated institutions typically have many complex recovery options that may involve disposal of businesses or capital-raising. Given the nature of these recovery options and the likelihood that these extraordinary actions will have to be approved and implemented in short order during severe stress, it is critical that the board of directors are aware of the recovery plan, its contents and their obligations with respect to recover options.

In comparison to locally incorporated institutions, however, foreign bank branches are typically less complex and relatively minor from a balance-sheet perspective and have a narrower set of recovery options. It is therefore more effective for approval authority to be given to the local management committee that oversees the foreign branch or to those individuals identified in the MIC or Management Accountability regime. This would ensure that approval authority resides with those who have substantial knowledge and expertise of the branch's operations and the nuances of the Hong Kong and Asia-Pacific markets where the branch operates. We wish to reiterate that the requirement to submit a Hong Kong recovery plan is atypical of other jurisdictions.

Recommendation: Provide confirmation that branches of foreign banking organisations may delegate authority for oversight and approval of recovery plans to a suitable committee of the branch. Provide additional guidance on when branches are significant enough to require a degree of involvement from group senior management in the review and approval process for foreign bank branch recovery plans, and guidance on the level of involvement required and the frequency of those approvals. We would also suggest that for third-wave institutions, approvals should be required every two years rather than annually – such proposals have been made in the US and are commensurate to the risks posed by such institutions to the Hong Kong financial system.

Interaction between group and local plan: As an international financial centre, Hong Kong predominantly hosts institutions that have an overseas parent. Further guidance has been provided in the third wave on the interaction and conflicts between the group and local recovery plans, as well as the need for group oversight during the development process for the local recovery plan.

For AIs with smaller operations in Hong Kong, the use of the group recovery plan could be an appropriate choice, as the primary option available to smaller bank branches is to seek an injection of funding from the parent. The maintenance of a single, group-level plan may promote consistency and clarity in interactions and governance mechanisms in a stress scenario. To make it easier for AIs to use their group-level plans, more guidance is needed from the HKMA, notably around information exchange or Memorandums of Understanding (MoUs) between jurisdictions.

Regulators in different jurisdictions may have different requirements or expectations for the contents of the group-level recovery plan. This divergence may deter the use of a group recovery plan to fulfil local Hong Kong requirements, even when a single plan may be the most effective, realistic and credible recovery plan. Additionally, some institutions may be subject to data privacy, regulatory confidentiality or listing rules from their home jurisdiction that may inhibit the sharing of sensitive details included in the group-level recovery plan across borders, which may also deter the use of a single plan even though it may be the most effective approach.

Recommendation: Additional guidance is required on when it would be appropriate for a third-wave institution to submit its group recovery plan or a portion of its group recovery plan, as applicable to Hong Kong, to fulfil the requirements set forth by SPM RE-1. MoUs with jurisdictions will assist firms with information exchange by removing the prohibition against sharing group recovery plans with the HKMA.

Additionally, ASIFMA would appreciate clarification on whether the HKMA would allow foreign branches to submit its group level or a portion of its group level recovery plan, in cases where the home country recovery planning requirements may diverge from the requirements set forth by SPM RE-1. Members recommend the HKMA take an outcomes-based and proportional approach to divergences rather than a granular assessment, especially for third-wave branches.

Members also request confirmation from the HKMA as to whether, where a local plan is produced, the interaction between the local plan and the group plan, including those points raised in paragraph 2.2 of SPM RE-1, can be demonstrated to the HKMA's satisfaction by attestation from a suitable senior manager of either the Hong Kong Branch or head office.

Independent Review and Challenge: Global financial institutions have involved independent parties – such as independent risk organisations, internal audit or third-party providers – to review and challenge their recovery plans to ensure that they are feasible, actionable and comply with regulatory requirements.

Typically, Treasury, Risk, Finance and Lines of Business are responsible for providing business information, drafting the recovery plan, implementing the core capabilities necessary to deploy the recovery plan and then integrate the recovery plan into business processes. Institutions have also appointed independent parties to oversee, review and challenge the components of the recovery plan, including the assumptions, methodologies, judgments, data and projections incorporated into the plan to ensure their accuracy and defensibility. Specifically, the PRA requires that, prior to submission, the institution demonstrate that senior management and the board of directors have sufficiently challenged the recovery plan and that an independent party conducted an assessment of the plan. This helps to promote a strong risk culture and ensures that a comprehensive system of checks and balances are in place. It should be noted this is carried out at a parent entity level for group recovery plans. For foreign branches that rely on a group recovery plan, the independent review and challenge occurs at the parent entity level.

Though not explicitly required, institutions in the US have added another layer of assurance by requiring that recovery planning models be subject to model validation and model risk management standards. This practice helps confirm that the assumptions underpinning the models are sound and that the model is performing as expected.

Recommendation: For locally incorporated entities, clarify the independent review requirement currently detailed in supervisory letters sent directly to institutions, particularly the expectations and outputs of an independent reviewer.

Integration with Risk Management Framework: Global regulatory authorities have continued to stress that recovery plans should not be drafted in a vacuum. Recovery forms just one component of a bank's operating continuum from business-as-usual to resolution. Recovery plans need to be integrated and consistent with all other components along that continuum to be sustainable and further demonstrate that the institution has a cohesive risk-management strategy.

The capabilities, methodologies and processes defined for recovery planning should be integrated into an institution's existing funding, liquidity and capital management practices. To accomplish this, institutions have ensured alignment between recovery triggers and the limits, metrics and early warning indicators ("EWI") included in the firm's risk appetite statement, contingency funding plan and capital contingency plan. Specifically, for scenario analysis, there should be consistency between the methodologies and assumptions defined for recovery planning and those defined for business-as-usual stress testing. A practical example of this is the strategic management actions taken in a recovery scenario versus a milder stress. In a recovery scenario, management would be willing to take franchise-damaging actions, which should progress consistently from the less punitive actions taken in a milder stress. Some leading jurisdictions have also started to require that institutions develop a single process to respond to liquidity stress. This includes combining the contingency funding plan and the recovery plan so that conflicts and misalignments can be eliminated.

Additionally, to integrate recovery planning into business-as-usual processes, institutions have formalised the governance framework associated with recovery planning by updating policies, procedures, roles and responsibilities documentation and committee charters. Senior management at these institutions also consider recoverability as a key criteria in strategic decision-making such as new business or product approvals along with mergers and acquisitions.

Recommendation: Provide more explicit guidance in sections 2.2.1 and 3.2.5 of the SPM RE-1 on how the HKMA expects an institution to embed recovery planning into its business-as-usual risk management framework and detail how the HKMA would evaluate the effectiveness of these processes.

CONCLUSION

As the HKMA continues to review and update the SPM RE-1 in 2018, the HKMA should give due consideration to the applicability and proportionality of each requirements on the range of institutions and legal entity structures that make up the Hong Kong banking sector. While many of these requirements may be applicable for large, locally incorporated institutions that are systemically important and provide critical functions to the Hong Kong economy, they may not be as relevant for smaller, locally incorporated AIs and foreign bank branches with more limited operations. Therefore, the HKMA should more specifically outline its expectations for third-wave institutions in developing and maintaining a local recovery plan.