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RECOVERY PLANNING

Build Resilience. Restore Trust.

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Deloitte's Views in response to BNM's Exposure Draft on Recovery Planning, published on the 17th January 2020

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SECTION 1:
OVERVIEW OF BNM'S ED ON RECOVERY PLANNING

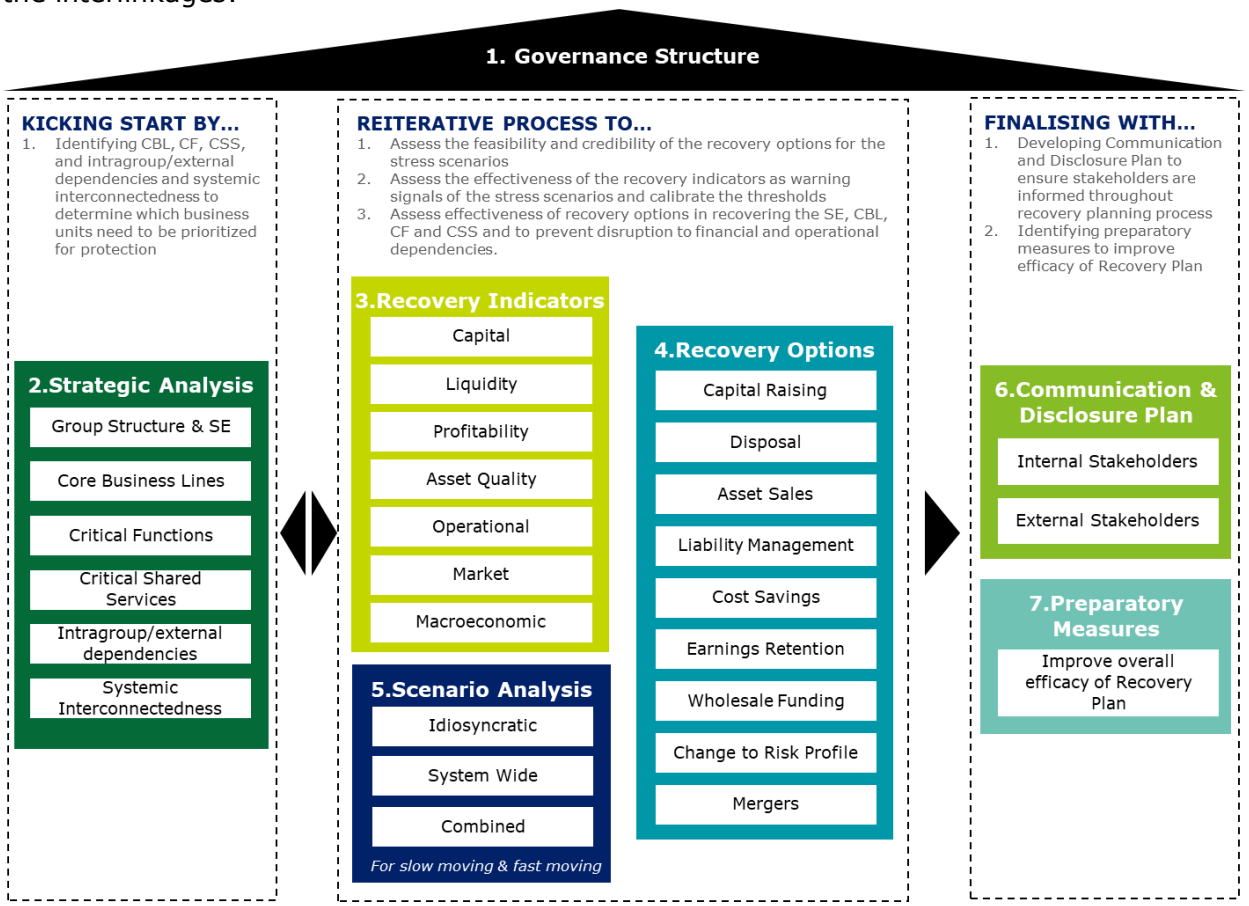
In the aftermath of the Global Financial Crisis, Recovery and Resolution Planning (RRP) has been introduced to strengthen the crisis preparedness of Financial Institutions ("FI"), especially "Too-Big-to-Fails". In Malaysia, we have witnessed FIs failing during the 1997 Asian Financial Crisis and government agencies, such as Pengurusan Danaharta Nasional Berhad (Danaharta) and Danamodal Nasional Berhad (Danamodal) stepping in to recapitalize and restructure those FIs. In total, RM 6.4billion was injected into 10 banking groups. An effective RRP aims to minimise the need for public funding, while allowing the FI to be resolved in a more orderly manner.

To date, there is no official timeline as to when the full roll-out of Recovery Planning in Malaysia will be enforced, although many industry practitioners anticipate that the coming year end will mark its long-awaited finalization.

HERE IS WHAT YOU NEED TO KNOW ABOUT RECOVERY PLANNING

Although there is an uncertainty over the when, it is clear that implementing Recovery Planning will present its own set of challenges. Banks need to understand what RRP truly entails and how best to leverage on industry practices to build Recovery Plans that are not just theoretically comprehensive, but also operationally feasible during an actual stress scenario.

There are seven (7) essential components and the diagram below presents a summary of the interlinkages:



SUMMARISING THE ED REQUIREMENTS ON RECOVERY PLANNING…

Component 1: Governance Structure & Oversight
The first overarching component in BNM's ED on Recovery Planning sets out clear governance arrangements related to the development, maintenance and activation of Recovery Plans. Responsibilities and procedures need to be clear and streamlined because, in an emergency situation, it is critical that decisions and actions are taken as fast as possible.

Para 12.4 of the ED also emphasised the role of Shariah Committee to advise on Shariah requirements consistent with the Bank's Shariah Governance Policy Document.

Component 2: Strategic Analysis
Strategic Analysis forms a critical step in Recovery Planning and involves the identification of the following:

1. Significant Entity (SE);
2. Core Business Line (CBL);
3. Critical Function (CF); and
4. Critical Shared Services (CSSs)

The identification of the above is important in the context of Recovery Planning, to determine which business activities need to be protected and continued to restore the FI's long-term viability and whether recovery options could be implemented without any significant adverse impacts on the financial system and maintenance of the CBLs, CFs, or CSSs. In achieving this objective, FIs are also required to perform an analysis of intragroup dependencies, external dependencies, and systemic interconnectedness to be comprehensively done.

In the table below, we present the definition of some of these important terms as outlined in the ED and how we can identify them:

Term	Definition	Identification
Significant Entity (SE)	**Significant Entities** are legal entity that: • is a licensed person under the FSA or IFSA; • contributes materially to the FI's profit, assets, capital, liabilities, risk profile, reputation or franchise value; • performs core business lines or critical functions; • has material intra-group dependencies, e.g. performs key operational services that support core business lines and critical functions; • could threaten the viability of the FI in the event of the entity's failure, liquidation, or the disposal of all or part of its business; or • is designated or deemed to be systemically important to the jurisdiction it operates in.	In the application of these criteria, SE identification can undertake financial based analysis based on the previous three years of financial results, thereby mitigating the risk of significant single point variances.

Term	Definition	Identification
Core Business Line (CBL)	**Core Business Lines** are business lines that are significant to an FI	The identification of CBLs would be FI specific as they reflect the current organisational model. At a minimum it should consider: • **Contribution of the business line** to the FI's profit, assets, capital, liabilities, or risk profile • **Strategic significance** of the business line
Critical Function (CF)	**Critical functions** refer to underlying operations, activities or services that are performed by an FI for third parties where the failure or discontinuance of such function would likely lead to the disruption of services that are essential for the functioning of the real economy and financial stability	The identification of CFs should consider the following: • **Concentration** – FIs market share of the function • **Impact of discontinuance** – impact on customers and relevant stakeholders affected by the function • **Substitutability** – degree of market concentration, capacity of substitute providers, expected time needed for substitution, willingness of substitute providers, ease of customers to move over, necessary requirements to perform the function • **Interconnectedness** – interactions with other functions of the FI or of the market
Critical Shared Services (CSS)	**Critical Shared Services** refer to the underlying operations, activities or services that are performed for one or more covered entities, where the failure or discontinuance of such services would present a serious impediment or completely impair the performance of one or more critical functions	The identification of CSSs should consider the following: • **Impact of discontinuance** - impact on critical functions • **Substitutability** – availability and ease to be replaced with similar cost, comparable quality and reasonable timeframe

Term	Definition	Identification
Intragroup Dependencies	**Intragroup Dependencies** refer to material interdependencies among covered entities, and entities related to the FI that, if disrupted, would significantly affect the funding or operations of the FI and/or its performance of CFs	The identification of Intragroup Dependencies should consider the following: • **Financial dependencies** – extent of FI's reliance on intragroup capital, funding and liquidity arrangements • **Operational dependencies** – extent of FI's reliance on internal service providers • **Legal/Structural dependencies**
External Dependencies	**External Dependencies** refer to material dependencies on third parties by the FI that, if disrupted, would significantly affect the funding or operations of the FI and/or its performance of CF	The identification of External Dependencies should consider the following: • **Financial dependencies** – extent of FI's reliance on external counterparties • **Operational dependencies** – extent of FI's reliance on external service providers • **Legal/Structural dependencies**
Systemic Interconnectedness	**Systemic Interconnectedness** refer to material dependencies on the FI by third parties that, if disrupted, would likely lead to the disruption of the functioning of the real economy and financial system	The identification of Systemic Interconnectedness should consider the following: • **Financial connectedness** – significance of FI's role in providing funding, liquidity or risk transfer to third parties, financial markets, and FMIs • **Operational dependencies** – extent of FI's role in providing/ performing activities, functions or services that are potentially essential for the functioning of the real economy and financial system

Component 3: Recovery Indicators

The next component is recovery indicators which focus on establishing a set of quantitative and qualitative indicators to allow for proper and regular monitoring of potential risks and therefore, a timely activation of the Recovery Plan.

The ED requires for recovery thresholds and early warning signals of each of the recovery indicators to be calibrated based on the outcomes of the stress scenarios, taking into consideration the following three factors:

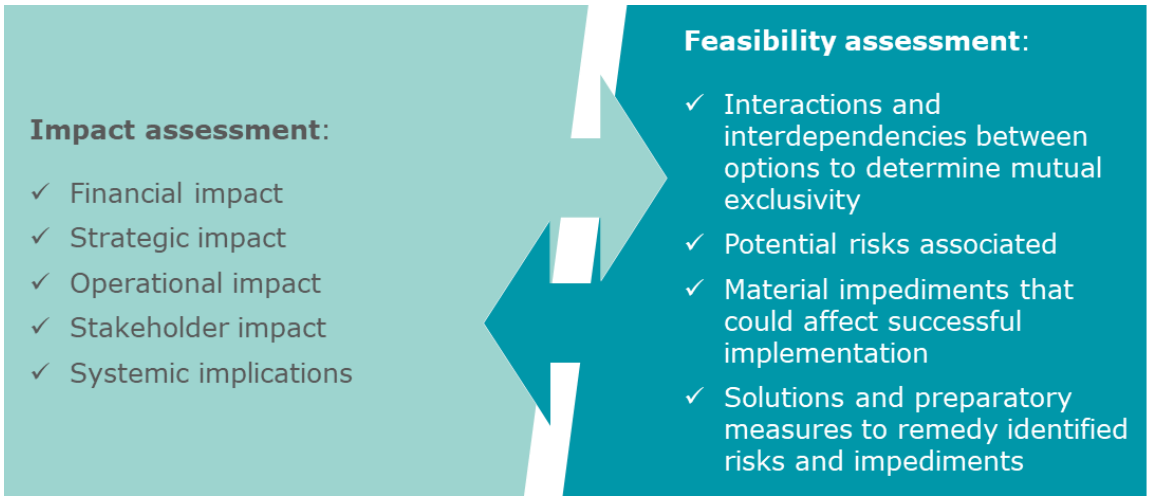
- Impact and time required for successful implementation of recovery options;
- Magnitude and speed of deterioration under various stress scenarios; and
- Alignment with financial institutions' risk appetite and risk management frameworks, including interactions with risk limits/thresholds identified under the existing risk monitoring, escalation and decision-making frameworks during BAU and early warning phases.

In the figure below, we present the seven (7) categories and respective recovery indicators outlined in the ED:

Component 4: Recovery Options

Recovery Options outline and rank in order of feasibility and credibility, a sufficient number of plausible options to enable an FI counter a scenario of stress effectively. A comprehensive assessment of each recovery option is a key input in determining the overall recovery capacity of an FI.

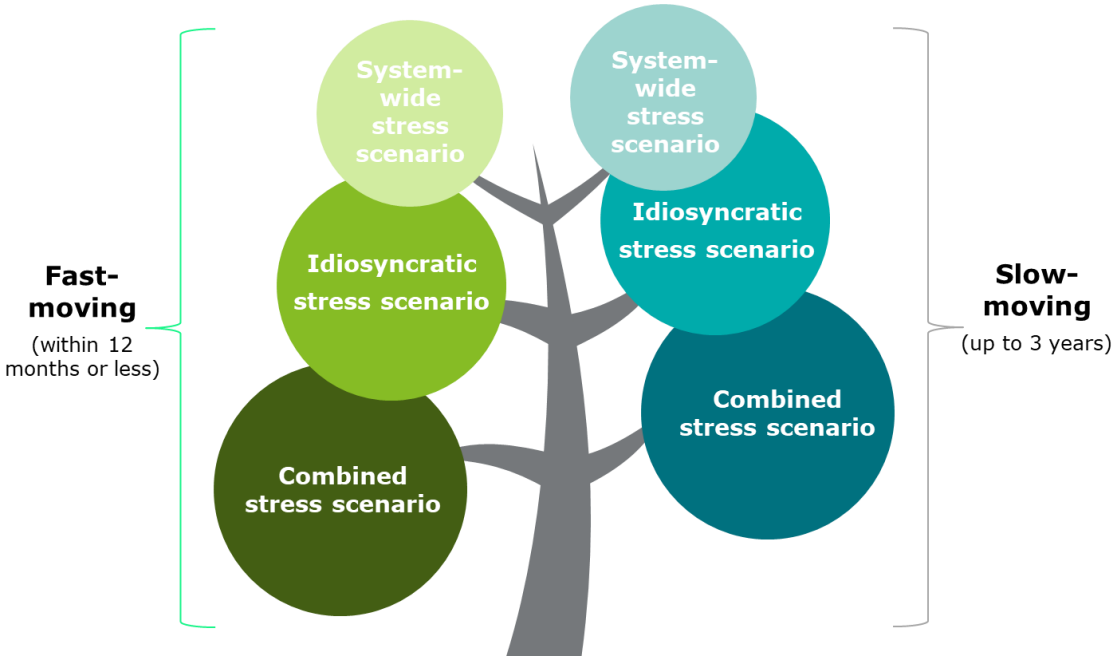
The ED requires for each recovery option to be assessed from both the following two perspectives:



Component 5: Scenario Analysis

Scenario Analysis focuses on designing comprehensive stress scenarios, both quantitatively and qualitatively. The scenarios play a key role in testing out the feasibility and credibility of the recovery options and the effectiveness of the recovery indicators as warning signals.

At a minimum, the ED requires the following scenarios to be assessed:



Component 6: Communication & Disclosure Plan

The Communication and Disclosure Plan aims to ensure that all the relevant stakeholders are promptly and adequately informed in regards to the implementation and activation of the Recovery Plan.

The ED requires that in determining the mix of communication channels and communication strategies during recovery, the following should be considered:

- Varying communication needs of different stakeholders;
- Specific communication needs of individual recovery options and / or preferred recovery strategies; and
- Applicable disclosure requirements (e.g. legal provisions, regulations, or listing rules), particularly in relation to unpublished, price-sensitive information.

Component 7: Preparatory Measures

Last but not least, the final component of the Recovery Plan aims to improve the overall efficacy of the Recovery Plan by removing impediments identified.

The ED requires the following to be documented for each of the preparatory measure proposed by the FI:

- Implementation timeline;
- Target completion dates;
- Resources required and estimated costs; and
- Personnel responsible.

SECTION 2: REGIONAL BENCHMARKING: HONG KONG AND SINGAPORE

		MALAYSIA (BNM)	HONG KONG (HKMA)[1]	SINGAPORE (MAS)[2]
APPLICATION	On Principle of Proportionality	**No,** *same requirements apply to all Financial Institutions (FI) on a consolidated basis*	**Yes,** *different levels of information depending on significance of operations*	**No,** *same requirements apply to all Financial Institutions (FI) on a consolidated basis*
APPLICATION	On implementation of Recovery Planning	**Not specified**	**Phased Implementation,** *with priority accorded to systemically significant/critical Authorized Institutions (AI)*	**One-off exercise,** *applies to Banks to which a directive has been issued by MAS*
SUBMISSION	On timeline for submission	**12 Months**	**6 Months**	**Not specified**
SUBMISSION	On availability of Data Templates	**Yes,** *data template provided for each core component of Recovery Planning*	**No,** *data templates are not publicly available*	**No,** *data templates are not publicly available*
ACTIVATION	On selection of Recovery Triggers	**Detailed listing provided,** *covering Capital, Liquidity, Operational, Asset Quality, Operational, Market & Macroeconomic*	**Not specified,** *HKMA provided a few examples but requires AI to tailor based on business and operations*	**Not specified,** *MAS requires FIs to have both qualitative and quantitative metrics including leading indicators*
ACTIVATION	On development of stress scenarios	**Min 3 scenarios,** *idiosyncratic, system wide and combined event (including slow moving and fast moving for each event)*	**Min 3 scenarios,** *idiosyncratic, system wide and combined event (larger AIs to also consider slow moving and fast moving events)*	**Min 3 scenarios,** *idiosyncratic, system wide and simultaneous stress situations*
ACTIVATION	On selection of Recovery Options	**Detailed listing provided,** *FI to assess applicability for each option*	**Not specified**, *HKMA provided a few examples but requires options to be diverse and include disposal*	**Not specified**
ACTIVATION	On ranking of Recovery Options	**Yes,** *options within preferred recovery strategy ranked by sequence & efficacy*	**No**, *options not ranked as preferred recovery strategies are not required*	**Not specified**
ACTIVATION	On timeframe for activation of the Recovery Options	**Not specified,** *Recovery Options should be capable of being executed within an "appropriate timeframe"*	**<6 Months,** *HKMA views that recovery option should not take longer to take effect*	**Not specified**

Note:
1. HKMA – Supervisory Policy Manual/RE-1/Recovery Planning/V1 – 20.06.14
2. Guidelines to MAS Notice 654 on Recovery and Resolution Planning

SECTION 3: RESPONDING TO BNM'S QUESTIONS IN ED

QUESTION 1: *[BNM Exposure Draft – RRP, page 11]*

Is 12 months sufficient for financial institutions to develop their first recovery plan? Alternatively, please suggest an appropriate timeframe and how the extended timeframe would be used to develop the recovery plan.

Generally, time taken to develop a Recovery Plan would be dependent on the complexity and size of the FI's operations. We view that on average it would take a mid-size bank 6 – 8 months to complete the development and independent validation of a Recovery Plan and a larger size bank with extensive regional operations, 8 – 10 months. In view of this, the 12 months proposed does appear to be a reasonable timeframe.

However, we note that Recovery Planning should not stop at just developing a documentation (that runs into hundreds of pages) for BNM's submission purposes. Any extended timeframe given to FIs should be used to ensure the usability of the Recovery Plan. FIs can consider:

(1) Developing playbooks to serve as a quick guide to make it easier for the management and for the Board to quickly navigate the Recovery Plan.
(2) Designing dry runs, simulating fast moving shock events to test the proficiency of the Board and Senior Management in coordinating a crisis and their familiarity with the Recovery Plan.
(3) Integrating with the existing risk appetite and risk management frameworks of the FI to form an integral part of the enterprise wide risk management activities.

QUESTION 2: *[BNM Exposure Draft – RRP, page 22]*

Do you agree with the roles/responsibilities prescribed for the board, senior officers and SC? Please explain any specific concerns along with constructive suggestions for the Bank to consider other than those identified in paragraphs 12.2 to 12.4.

The roles and responsibilities prescribed for Board and Senior Management are generally aligned with those outlined by other regulators such as HKMA and MAS but are mostly focused on the pre-recovery phase (i.e. development and maintenance of Recovery Plan) with lesser emphasis placed on during recovery phase (i.e. activation of Recovery Plan).

We view that in an actual crisis, the activation of the Recovery Plan is most critical and hence FIs should be given more guidance on the governance aspects of this. One example is to outline the degree of involvement of the Board in overseeing the execution of Recovery Plan.

In addition, we also find that establishing the roles and responsibilities to assess the feasibility and effectiveness of the Recovery Plans is of key importance. For example, Board and Senior Management can be tasked with designing and overseeing dry runs to rectify deficiencies in the Recovery Plan.

The precision of mandates and responsibilities outlined for each of the level of the governance (i.e. Board, CEO, CRO, CFO, Business Line Managers, and Internal Audit) as depicted in FSB's paper on *Principles for an Effective Risk Appetite Framework*, should be upheld as the best practice when it comes to governance.

QUESTION 3: *[BNM Exposure Draft – RRP, page 25]*

Do the above categories cover the universe of recovery/early-warning indicators that financial institutions typically monitor for risk management purposes? Are there any other relevant categories that should be included above? Are there any categories for which financial institutions presently do not have recovery / early warning indicators? If so, please elaborate on why such categories are not monitored.

In our view, the categories of recovery/early-warning indicators highlighted in the ED (i.e. Capital, Liquidity, Profitability, Asset Quality, Operational Risk, Market and Macroeconomic) are rather comprehensive. We note that BNM's move to introduce one additional category of indicators, Operational Risk (in addition to the 6 pre-existing in EBA's report) emphasises the importance of integrating with the existing risk management practices of monitoring Key Risk Indicators (KRI) arising from Operational Risk.

However, the possibility of having to monitor 30 or more recovery triggers (outlined in *Appendix 7 of the ED*) brings into question the effort and additional resources required to operationalize them (i.e. calibrating and on-going monitoring of thresholds).

We note that FIs may have concerns in accepting the Market and Macroeconomic indicators as Recovery Indicators, as the general view is that these typically represent market perceptions which bear minimal significance to the FI's overall financial stability. Recent industry research however, shows that Market and Macroeconomic variables performs better than traditional ratios such as Tier 1 Capital in signaling an FI's failure ahead of a global financial crisis, due to its nature as leading indicators. This is observed in the market factors (e.g. implied volatility and credit default swap spreads) of the failed FIs and the accelerated speed at which the ratios fell, even before the crisis hit.

QUESTION 4: *[BNM Exposure Draft – RRP, page 30]*

Is the explanation and/or guidance set out for recovery options involving Islamic entities sufficient to determine feasible and viable recovery options for Islamic entities? If further elaboration or guidance is needed, please explain which part specifically should be further elaborated.

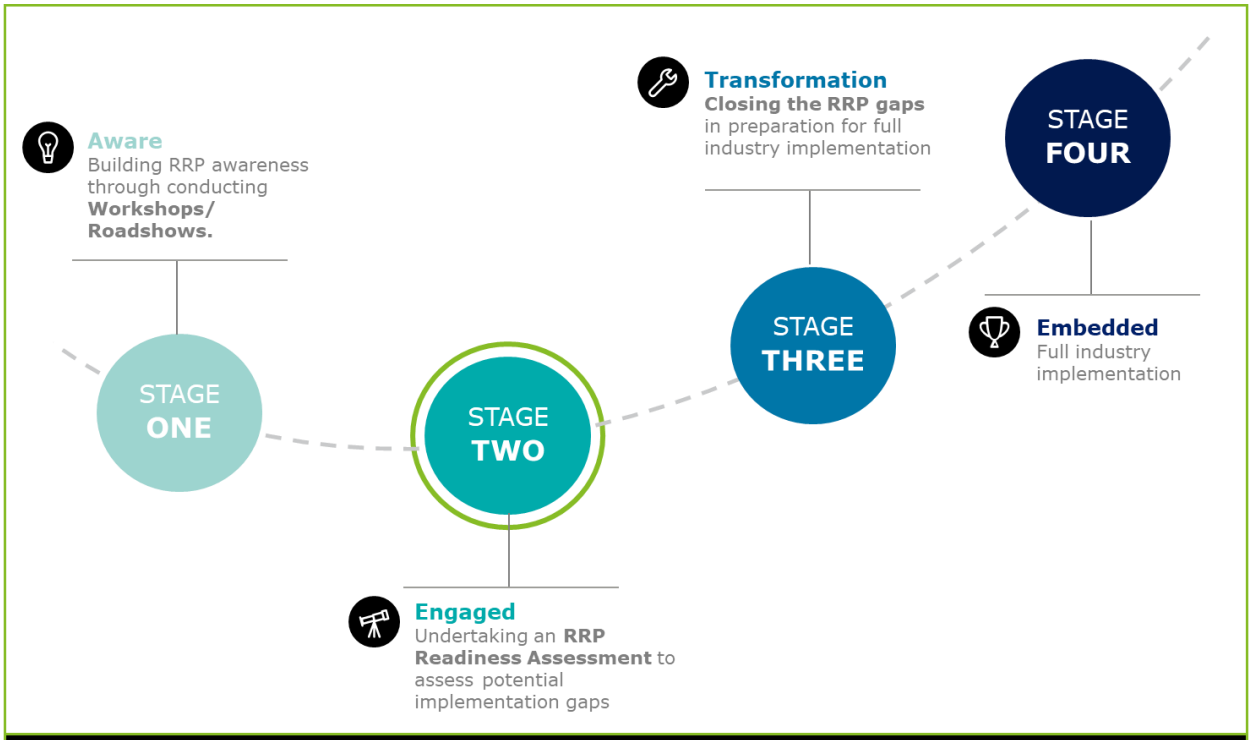
Conceptually, the unique rights and liabilities of Islamic Banking Products would have an implication on the recovery and resolution options. For example, distressed sales in a recovery scenario would often have to be done with the understanding that haircuts would need to be taken against the value of the asset, but Islamic Practitioners have held that debt assets cannot be sold at lesser than its par value, as the discount can be interpreted as "interest".

We note that the ED discusses the issue pertaining to transfer of assets, but only highlights for recovery options involving transfers to have "acceptable transfer mechanism taking into consideration the prospective transferee's preferred method".

We also deliberate the feasibility of transferring or selling assets to Shariah-compliant entities in circumstances where all IFIs are in the midst of a similar stress event. We view that such restrictions can affect the survivability of the IFI where no alternatives are available. Vice versa, limiting assistance to non-Shariah compliant entities may also affect the recovery of a conventional FI which seemingly appears to be at odds with the fundamentals of a Recovery Plan.

In order to ensure the practicability of the Recovery Plan, additional guidance can be provided to assist IFIs in addressing the challenges of upholding the Shariah principles during a crisis.

SECTION 4: WHAT'S YOUR GAME PLAN FOR RECOVERY PLANNING?



In our view, most FIs are at STAGE 2.
We propose for FIs to consider the following immediate next steps...

1	2	3	4
Designing additional **recovery triggers** leveraging on existing risk appetite statements	Designing **stress scenarios and reverse stress scenarios** leveraging on existing scenarios built for ICAAP submissions	Identifying potential **recovery options** leveraging on existing Business Continuity Plans & Capital Contingency Framework	Testing the **availability of data** required to complete the **Data Templates**

Contact Us

Justin Ong
FSI Financial &
Regulatory Risk Leader
Deloitte Malaysia
keaong@deloitte.com
D: +60(3) 7610 8895

Deloitte.