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Recovery and Resolution Planning for Systemically Important Financial Institutions:

Guidance on Recovery Triggers and Stress Scenarios

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Introduction

The *FSB Key Attributes of Effective Resolution Regimes for Financial Institutions ('Key Attributes'* or KAs*)*[1] state that jurisdictions should require robust and credible recovery plans for all G-SIFIs and for any other firm assessed by its home authority as potentially having an impact on financial stability in the event of its failure (KA 11.5). The responsibility for developing and maintaining and, where necessary, executing the recovery plan lies with the firm's senior management. Authorities should review the recovery plan as part of the overall supervisory process, assessing its credibility and whether it can be effectively implemented (KAs Annex III, 1.6).

Recovery plans should set out options to restore financial strength and viability when the firm comes under severe stress. They should include, among other elements:

1. analyses of vulnerabilities associated with the nature, size, and complexity of the firm's operations, its business model, interconnectedness and associated risk profile;
2. criteria (quantitative and qualitative) for identifying when an event has occurred or a situation is developing that requires senior management attention, designed to prevent undue delays in addressing a recovery situation ("triggers");
3. credible options to cope with a wide range of scenarios including both idiosyncratic and market wide stress, and a robust assessment of these options, their comparative analysis, and key factors that may affect their implementation;
4. stress scenarios that address capital shortfalls and liquidity pressures;
5. processes to ensure timely implementation of recovery options in a range of stress situations; and
6. analyses of impediments that could have a negative impact on the execution of recovery actions and associated action plans.

For details, see Section 3 of *Essential Elements of Recovery and Resolution Plans*, Annex III.

This Guidance focuses on two specific aspects of recovery plans:

(i) the design and nature of criteria triggering senior management consideration of recovery actions ("triggers"), a firm's reactions to breached triggers, and engagement by supervisory and resolution authorities following breached triggers; and

(ii) the severity of hypothetical stress scenarios and the design of stress scenarios more generally.

This Guidance complements the guidance on recovery plans set out in Annex III to the *Key Attributes.* It should benefit Crisis Management Groups (CMGs) as they work towards implementing the G-SIFI requirements, while also supporting individual authorities seeking to build on initial recovery plan iterations.

The observations and guidance herein focus on triggers and stress scenarios only. This document should not be interpreted to mean that triggers and stress scenarios are the most

[1] http://www.financialstabilityboard.org/publications/r_111104cc.pdf

important elements of recovery planning. It is aimed to support recovery planning for globally systemically important banks (G-SIBs). However, some aspects may also be relevant for resolution planning for domestic systemically important banks (D-SIBs) or non-bank financial institutions.

Sections 1 and 2 below describe the emerging practices in these two areas of recovery planning. Section 3 offers guidance aimed at regulators, supervisors and resolution authorities, especially those that participate in CMGs for G-SIFIs.

1. Quantitative and qualitative triggers and early warning indicators

The aim of triggers in recovery planning is to enable firms to maintain or restore financial strength and viability *before* regulatory authorities see the need to intervene or enforce recovery measures. Such triggers are generally understood as a pre-identified point in time, situation or marker, which requires the firm to notify senior management or its board, and its supervisory authority, that a triggering event has occurred.

Although a triggering event usually results in the firm taking a recovery action, a recovery action may not necessarily be required. The expected result of a triggering event is an escalation to senior management in order to implement a discretionary response in accordance with the specificities of the situation. Triggers generally are not linked to specific compulsory recovery actions. A breach of a trigger will typically require attention by senior management or the Board so that an appropriate response can be made on a case-by-case basis. It may also require the firm to discuss with its supervisory authority whether a particular recovery action set out in the recovery plan should be implemented.

Some G-SIFIs do not identify triggers for the specific purpose of recovery planning. Instead, they rely on the firm's broader risk management framework, in particular early warning indicators, which are part of the firm's internal risk management processes.

G-SIFIs use both quantitative and qualitative triggers in their recovery plans. The number and combination of quantitative and qualitative triggers varies by G-SIFI and may be set out by its supervisor. The triggers are predominantly quantitative and are focused on firm-specific liquidity and capital measures.

The quantitative triggers often focus on the extent or speed of change in different elements, such as:

- ratings downgrades;
- revenue reports or P&L (or components of these);
- credit risk limits;
- equity ratios;
- per cent renewal of wholesale financing;
- withdrawal of deposits and other funding;
- increased collateral requirements;
- market-based leverage ratios;
- a three-month interbank rate; and
- senior debt and subordinated debt spreads.

Qualitative triggers are also an important component, though the use of such triggers in recovery plans is currently much less widespread than quantitative triggers. Qualitative triggers could include elements such as: requests from counterparties for early redemption of liabilities; difficulties in issuing liabilities at current market rates; an unexpected loss of senior management; adverse court rulings; negative market press and significant reputational damage.

In addition to triggers, early warning indicators may be used by G-SIFIs to signal negative trends and are monitored on a business-as-usual basis. These indicators are conceptually similar to triggers, but are distinguished primarily by their position on the recovery timeline; an early warning indicator would be calibrated so that it alerts the firm to adverse circumstances earlier than a recovery trigger, which better prepares the firm for a potential triggering event.

2. Stress scenarios

G-SIFIs typically use two to four stress scenarios for recovery planning purposes. G-SIFIs employ both systemic or market-wide and idiosyncratic stress scenarios, and in many cases a combination of the two scenarios (usually based on the same assumptions in the individual scenarios). G-SIFIs have tended to include a wide range of elements within these various stress scenarios. The number of scenarios generally depends on the individual G-SIFI and the guidance of the relevant supervisory authority. Some firms employ existing stress scenarios or criteria developed by regulatory authorities.

Many G-SIFIs have developed at least one systemic or market-wide scenario and at least one idiosyncratic or firm-specific scenario. Some G-SIFIs have developed scenarios that combine a systemic and idiosyncratic situation, as well as scenarios for both slow-moving and fast-moving financial crises. Scenarios range in severity and typically include a number of components. The following elements are frequently used by G-SIFIs as components of their stress scenarios:

- significant capital and liquidity impacts;
- severe losses through a rogue trader;
- rating downgrades;
- a Euro or US dollar crisis;
- decreasing GDP growth rates;
- loss of goodwill;
- exodus of talent;
- significant deposit withdrawal or runoff;
- collapse of global financial markets;
- rise in public debt;
- significant changes in currency rates;
- significant changes in commodity prices;
- bank failures;
- fraud; and
- reputational crises.

Some G-SIFIs also perform reverse stress testing. Reverse stress testing assumes the failure of the business model and identifies circumstances in which this may occur, rather than testing for outcomes arising from changes in circumstances of different likelihoods. Reverse stress tests can be seen as a starting point for developing scenarios to test the effectiveness of the menu of recovery options.

3. General guidance

CMGs and national authorities should consider the following as they set their expectations for recovery plans and as they conduct reviews of recovery plans developed by the firms.

Calibration of triggers

- Firms' triggers should be calibrated so that they provide sufficient notice to allow the firm to take corrective action and for the supervisory authority to begin appropriate contingency planning for taking early intervention measures, if this should become necessary.
- Firms should be required to provide supervisors and resolution authorities with an explanation of how the trigger calibrations were determined and an analysis that demonstrates that the triggers would be breached early enough to be effective.
- Triggers should not be linked to inherently lagging metrics, no matter how the triggers are calibrated.
- Firms should not rely solely on quantitative triggers, but should also incorporate qualitative triggers in their consideration of whether a recovery response is necessary and, if so, what kind of response would be appropriate. Greater inclusion of qualitative firm-specific metrics allows a firm's decision makers to develop an appropriate discretionary response on a case-by-case basis.
- The number of triggers should be appropriate for the firm's breadth of business and risk profile. A sufficient number of triggers should be used so that the firm is alerted to deteriorating conditions in a variety of areas, but not so many that the triggers become poorly targeted and unmanageable.

Incorporation into the overall risk management framework

- Triggers for recovery planning should be incorporated into the firms' overall risk management frameworks. Recovery triggers should be aligned with (but not be limited to) existing triggers for liquidity or capital contingency plans, early warning indicators and the firm's risk appetite.
- Triggers for recovery planning should be complemented by early warning indicators that alert the firm to emerging signs of stress that do not yet give rise to a triggering event.

Escalation process at triggering event

- Recovery plans should be clear about what processes should occur when triggers are breached. The supervisory and resolution authorities should be provided with detailed information about the escalation process to a firm's senior management or board of directors when triggers are breached, and about the decision-making process once those individuals have been informed.

- There should be the expectation that the breach of a trigger causes a predetermined escalation and information process up to senior management within the firm and between the firm and its supervisory authority. Whereas there should be a presumption that the firm needs to act when a trigger is breached, there should be no automaticity. Although a triggering event usually results in the firm taking a recovery action, an action may not be required in every case. Firms should retain flexibility to implement a discretionary response in accordance with the specificities of the situation and avoid market reactions that could be counterproductive in a stress scenario.

Communication with supervisory and resolution authorities

- Firms should be required to promptly communicate with supervisory authorities (and resolution authorities where appropriate) when the firm experiences high levels of stress or if triggers are breached.

Preparations for resolution

- When the firm experiences high levels of stress and triggers are breached, the authorities should consider preparations for resolution actions that might need to be taken if recovery measures do not succeed.

Stress scenarios

- Firms should use an appropriate number of market-wide (systemic) stress scenarios and firm-specific (idiosyncratic) stress scenarios to assess the robustness of their recovery plans and to assess which recovery options would be effective in a range of stress situations. Such assessments should comprise multi-dimensional analyses of key scenarios that could occur and affect a firm's structure, including more than one of each scenario and combining both systemic and idiosyncratic situations. These scenarios should address, inter alia, capital shortfalls and liquidity pressures and be severe enough to be useful in establishing triggers, estimating impacts of adverse situations, and contemplating responses to remediate both slow-moving and fast-moving adverse situations. They should also recognise that the price obtained for any disposal is likely to be reduced if other firms are seeking to make similar disposals at a time of market-wide distress.
- Firms should identify, assess and regularly update the scenarios most likely to cause their business model to become non-viable or to fail. Firms should include a range of credible options to be flexible enough to be effective in a variety of idiosyncratic and market-wide stress circumstances.
- Firms should be encouraged to combine market-wide (systemic) stress scenarios with more specific macroeconomic risk factors tailored to the firm's risk profile, thereby allowing the firms to estimate and model likely impacts, for example impacts on the income statement, balance sheet, Tier 1 risk-based capital, regulatory Tier 1 common equity, economic capital and material lines of business.
- Reverse stress testing can be a useful starting point for developing scenarios for recovery plans. Reverse stress testing identifies scenarios that would lead to a firm's business model becoming non-viable. Critical components of reverse stress tests

include identification and description of the point of non-viability in both quantitative and qualitative terms, and vulnerability analysis. Reverse stress-testing is based on a "default" or resolution scenario, meaning that the business model has already failed and recovery measures would not be effective. However, scenarios used for recovery planning should be only "near-default", as the aim of recovery planning is to describe options to ensure and restore financial strength and viability when the firm comes under severe stress.

Supervisory review

- The development and the use of triggers and stress scenarios for recovery plans should be subject to strong risk governance processes in the firm, including review by the board of directors. Triggers and stress scenarios should be reviewed by supervisors as part of their general supervisory programme and review of the recovery plan (although responsibility for developing and maintaining the recovery plan, including the triggers, remains with the senior management of the firm).