NOTES ON
CONTINGENCY PLANNING
Compass Guiding the Efforts of Official Financial Supervision
Keep Track of the Actions Taken and Assess their Impact on the Evolving Health of the Financial System
Disciplines Involved
Contingency Planning (CP)

• Permanent function in the organization;
• Coordinates Senior Management Officials in charge of:
  – Financial Regulation and Supervision of:
    • Bank, Non-Bank Financial Intermediaries, Groups;
  – Monetary Policy Operations, and to a lesser degree
  – Those in charge of macroeconomic analysis.
• Equip key elements for successful crisis management:
  – Timely, consistent, relevant, and reliable information;
  – Assurance of appropriate legal powers, readiness to act, resources
• Allows authorities to craft a rapid, consistent and comprehensive response to individual bank failures and systemic crisis management (SCM): **Have an Action Plan.**
CONTINGENCY PLANNING FOR SYSTEMIC CRISIS MANAGEMENT

**ACTORS**

- MACRO
- CENTRAL BANKING
- BANKING SUPERVISORS
- NON-BANKING FINANCIAL SUPERVISORS

**MONITORING**

- Data Warehousing
  - Connectability
- Supervisory Risk Assessments
  - Risk Profile Ratings
- Intensive Supervisory Plans
  - Conglomerate Wide
- Systemic Risk Mapping

**PLANNING**

- Simulation Exercises
  - Stress & War Games
- Alternative Action Plans
- Means for Actioning
  - Roles - Powers - Resources
- Technical & Financial Assistance

**ACTING**

- Public Communication
  - Policy
- Management Teams & Management Contracts
- Organized Resolution Vehicle
  - Multiyear Financing
  - Loss Absorption
- Designed Intervention & Resolution Process

**Vision of Future Financial System**

- Volumes, Costs & Spreads of Business Lines
- Required Capacity - Excess Capacity

- Consolidation of Excess Capacity
- Transformation of Public Banks
- Bank Types: Anchor - Failing - Surviving

- Trouble Corporate Debt
- Restructuring & Recovery

**Review & Feed Back**

- Efficiency & Effectiveness of Actions Taken

**Identification & Diagnostic of**

- Non-Bank Financial & Non-Financial Related Entities
Topics in Contingency Planning (CP) for Systemic Crisis Management (SCM)

- Monitoring macroeconomic volatility (sources, exposures, transmission)
- Tracking systemic risk factors: sources and exposures;
- Assessing the condition of banks beyond accounting;
- Early Prevention and Action to address problems;
- Preparedness to deal with failures efficiently: **Have Action Plan**;
- To minimize the impact on the economy and the tax payer.
- Identify and Track Major Sources of Systemic Risk;
- Organizational arrangements to deal with them;
- Strengthen key building blocks for effective SCM;
- **Systemic Risk Mapping**: tool to monitor systemic risk and assist in contingency planning for systemic crisis management
Key Sources of Systemic Risk

- Macroeconomic Volatility: Underlying Exposures
- Public Policies
- Changes in Market Structure and Competition
- Payment System Operations
- Bank Liquidity
- Corporate Governance
- Public Owned Banks (POB)
- Inter-Agency Coordination
- Money Laundering
- Off-balance sheet and offshore risks
- Connected lending risks
- Probability of runs on banks
Business Opportunities: Identification & Measures

Business Segments: Spreads - Risks - Leverage - Flows
Consumers' Demographics: Relevant Variables
Creditworthiness, Information and Depth of SME
Risk Interrelations among Sectors
Progress & Issues in State, Government & Sectoral Reform
Debt Recovery Process: Legal, Court, Politics, Procedures
Liquidity of Collateral

Economic Performance

Growth Drivers & Rates
GDP vs. Internal Credit
Stability of Growth
Employment - Demography
Corporate Solvency
Indebtness Levels
Public Debt Dynamics
Primary Surplus vs. Service

Risk Management Capacity

Mobilization Trend & Levels
Deposits: Level - Mix - Stability
Assessment of Effectiveness
Criteria Asignación Crédito
Credit Monitoring
Multidimensional Concentrations
FX Risk Transfer
IR Risk Transfer
Hedges & Hedgers

Internal Factors

Sectoral Over-Indebtness
Mismatched Terms & Flows
No Hedge - Wrong Hedge
Depressed Disposable Income
Volatile/Scarcie Cash Flows
Speculative Over-Indebtness
Business Cycle Severity Phase
Foreign Sources Dependency
Exported Systemic Risk

External Factors

Global Cycle - Growth Drivers
Capital Flows: Gyration/Profiles
Foreign Investment - Privatization
Foreign Multinationals
Host Sector Orientation
International Interest Rates - Premiums
Commodities: Price & Demand
Market Mood & Sentiment
International Bail-Out Policies
FMI - G7 - US

Credit Risk Management Processes

Portfolio Strategy & Mix
Diversification Policies & Possibilities
Lending Approach
Government Portfolio Risk
Loan Administration Practices
Loan & Asset Review Processes
Recovery, Work-Out, Restructuring

Financial System Stability

Capacity of Managers
Flow Solvency
Stock Solvency
Government Exposure
Foreign Competition
Foreign Financing Lines
Systemic Risks
Confidence by Depositors
Politics
Economic Powers

FINANCIAL SYSTEM CONDITION: EXPOSURES
Building Blocks for Effective Crisis Management

• Monitor to Plan, and then Act:
  - Information Ware Housing: Essential Data
  - Supervisory Powers: Ensure all powers needed
  - Readiness to Act: which banks are to be resolved
  - Simulation Exercises & War Games: Rehearsal
  - Roaster of Bank Management Teams
Simulation Exercises

- Determining the Condition of each Bank (problem vs. failing)
  - Viability in flow terms (liquidity) vs. solvency in stock terms
  - Banks that can earn their way out (cash flow earnings) of problems are viable
  - Banks that cannot earn their way out but have solid business might be restructured
  - Neither one, nor the other, are non-viable and would need resolution.
- Funding: Concentration, Volatility, Currency, Multi-Gap Profile
- Information Package Needed to Intervene
- Strategic Analysis of Resolution Techniques Under Current Framework
- (Legal) Authority and (Powers) to Intervene
- Legal Protection of Acting Officials
- Stakeholder Analysis
- Crisis Management & Public Communication Policies & Procedures
- Action Planning Set:
  - Parties responsible of executing plan
Systemic Risk Mapping

- Quantitative & Qualitative Information
- Systemic Data Warehousing (connectivity)
- Risk Ranking Methodology:
  - Rank banks by risk, size and complexity
  - Classify in categories of adversity in profiles
  - Track aggregate market share on each category
  - Changes & Level used to measure systemic vulnerability
- Risk Factors Grading Procedures: Critically-exposed; Over-exposed; Average-exposed; Mitigated-exposed; Low-exposed.
- Mitigation (demonstrated under reasonable conditions):
  - Ownership & Management Strengths (quality of risk management)
  - Bank Contingency Plan with Execution Process & Procedures
Methodology of Systemic Risk Mapping

1. Asset Quality: Multi-dimensional concentrations...
2. Liquidity: Concentrations, sources, executing plan...
3. Business strategy: volumes & spreads by major business line
4. Profitability: operational cash flow & negative contributors
5. Efficiency: cost flexibility of the operational structure
6. Capital adequacy: potential, economic, regulatory, accounting
7. Risk management: ability to identify & track exposures
8. Corporate governance: Oversight, Guidance, Support
9. Operational risk (IT/ EDP/ MIS, Ethics, Culture, Controls,...)
10. Sensitivity analysis: what if reasonably (downside-scenario)
11. Stress testing: what if all goes wrong (worst-case-scenario)
Evaluate Overall Loss Absorption, Reversal of Cash Flow Loss and Financing Requirements by Foreign Owner

Supervisor Carries Evaluation of Banks’ Viability

Requests Self-Assessment & Rehab Proposals

- Assumptions - Modeling - Criteria
- Business - Costs
- Projected Financials
- Is Bank Viable?
- Is Plan Feasible?
- Reasonability
- Loss Absorption
- Control Flow Loss
- Viability BENCHMARKS
  - Pure Top-Down Economic Criteria (cost-return)
  - Cost of Liquidate vs. Cost of Restructuring
  - Balance of liquidity flow going forward: gaps
  - Confidence demonstrated by clients
  - Feasibility of Reversing Flow Loss: downsizing costs
  - Speed of running losses and sources
  - Profile of bank: Systemic, Anchor, Marginal, Public
  - Needs & Level of CB’s rediscount vs. adjusted NW
  - Collateral Assets Available for Rediscount
  - Business Potential & Franchise: volumes & spreads
  - Commitment to Recapitalization by Owners
  - Quality of Owners / Interested Available Investors
  - Speed to recover CAR > 6% in (18-24) months
  - Feasibility of a “good” Privatization

Are Affordable Proposals of Loss Sharing and Liquidity Support needed to restore operational flows and mitigate mismatches?

- Close Bank as per Resolution Law and Pay Deposits Issue Liquidating License
- Evaluate M&A 30 D Assess Opportunities Set T Limit to Execution
- Liquidate Limiting Payoff Convert Deposits into Sub. or Equity Invest.

VIABILITY BENCHMARKS

For Systemic & Public Banks

- Evaluate Changes Necessary to Rehab. Plan for Adhering to Benchmarks
- Is Viability Confirmed?

Diagnostic

Public Banks

- Is Viability Confirmed?

YES

Monitor Compliance with Rehab Plan

NO

Plan Effective in Restoring Solvency?

Rehabilitation Vehicle Assumes % Loss Agreed
CB Commits Liquidity
Owner Commits to buy back % Loss

YES

Definite Approval of Rehab. Plan Including Recapitalization & Reorganization Commitments

NO

Temporary Approval of Rehab. Plan subject to Conditions & Target Diagnostic

EXAMPLE of RESOLUTION PROCESS
Technical Assistance Programs for Crisis Management

- Systemic Risk Assessment & Mapping
- Resolution Strategy and Action Plan
  - Institutional Arrangements: Resolution Vehicle
  - Official Coordination: Protocols
  - Management:
- Diagnostic Individual Banks:
  - Financial, operational, strategic, institutional
- Essential Legal Reforms Requirements
- Resolution Vehicle Operations
- Bank Restructuring
- Corporate Debt Restructuring