



Guidance Note: Pillar 2 in Jersey

Comprising an overview of the JFSC's expectations in respect of the application in Jersey of the internal capital adequacy assessment process (**ICAAP**) (of Basel II's Pillar 2) and the JFSC's related assessment process.

This is applicable only to deposit takers incorporated in Jersey.

Revised March 2017 to reflect new international standards regarding recovery planning, which is considered relevant to the development of contingency plans.

This revised guidance is applicable to all ICAAPs dated 1 October 2017 or later. Banks may opt to follow the revised guidance earlier.

Glossary of Terms

2013 Guidance Note	Revised Guidance Note <i>“Pillar 2 in Jersey”</i> , issued July 2013
Advanced Approaches	<p>Advanced Approaches, which are established in Pillar 1 of Basel II, permit banks to use risk models to calculate minimum regulatory capital requirements.</p> <p>These models must be developed in accordance with specific criteria set out in Basel II, including validation requirements. Approval must be obtained from the JFSC prior to use of any Advanced Approach.</p> <p>Advanced Approaches include:</p> <ul style="list-style-type: none"> › Advanced Measurement Approaches for the calculation of the operational risk capital requirement; › Internal Ratings Based approaches for the calculation of the credit risk capital requirement, which can be further divided into Foundation and Advanced variants; and › Internal Models Approaches for the calculation of the market risk capital requirement.
Basel I	Accepted short form for the original and previous BCBS capital adequacy framework for banks, published in its paper <i>“International Convergence of Capital Measurement and Capital Standards”</i> , issued in July 1988 and subsequently amended by various further papers.
Basel II	Accepted short form for the BCBS’s internationally recognised capital adequacy framework for internationally active banks, published in its paper <i>“International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version”</i> , issued in June 2006.
Basel 2.5	<i>“Enhancements to the Basel II framework”</i> , issued by the BCBS in July 2009
BCBS Stress testing paper	<i>“Principles for Sound Stress Testing Practices and Supervision”</i> , issued by the BCBS in May 2009
bank	Within this document, “bank” refers only to deposit takers registered and incorporated in Jersey.
Banking Code	Code of Practice for Deposit-taking Business, established under the Banking Law by the JFSC.
Banking Law	The Banking Business (Jersey) Law 1991, which is the primary legislation relating to the taking of deposits in Jersey.
BCBS	The Basel Committee on Banking Supervision, which is a multi-national body comprising representatives of central banks and banking regulators.
JFSC	Jersey Financial Services Commission.

CCR	Counterparty credit risk is the risk of loss if a counterparty to a transaction defaults.
CRM	Credit risk mitigation refers herein to the use of collateral, including guarantees, to reduce credit risk.
EWI	Early Warning Indicator. For this purpose, an indicator that the bank or the group it belongs to is becoming stressed.
FSB	Financial Stability Board, an international organisation tasked by the G20 group of countries with developing standards concerning bank recovery and resolution.
ICAAP	Internal Capital Adequacy Assessment Process. The term ICAAP is often used to refer to the document that records the considerations made and conclusions reached as a result of this process.
LCP	Liquidity Contingency Plan.
PII	Professional indemnity insurance, which provides cover for claims brought against the policyholder due to their professional negligence.
Pillar 1	One of the three Pillars established in Basel II, this deals with the formulaic calculation of minimum regulatory capital requirements in respect of credit, market and operational risk.
Pillar 1 RWA	The Pillar 1 Risk Weighted Amount is a risk adjusted measure of total exposures, which is multiplied by the minimum RAR to determine the minimum regulatory capital requirement for a particular bank. Conversely, the point-in-time RAR is calculated by dividing the capital base by the Pillar 1 RWA. Note, though, that this can be added to via the Pillar 2 process.
Pillar 2	One of the three Pillars established in Basel II, this covers a requirement for each bank to assess and record the full range of risks to which it is exposed, the mitigation it applies and any resultant capital requirement in addition to that generated under Pillar 1. The JFSC's approach to this is the subject of this guidance note.
RAR	The Risk Asset Ratio, which is the amount of capital held expressed as a percentage of its Pillar 1 RWA. The JFSC has established 10% as the minimum RAR for a bank incorporated in Jersey.
recovery plan	Contingency plans established to restore capital adequacy and maintain liquidity or otherwise mitigate the impact of stresses on the bank and its customers.
recovery trigger	Trigger for consideration of action in a recovery plan.
reverse stress tests	Reverse stress tests start from a known stress test outcome (such as breaching regulatory capital ratios, illiquidity or insolvency) and then ask what events could lead to such an outcome for the bank and how the bank's contingency plans would mitigate the impact.

risk weighting	Risk weightings are percentages set within the Standardised Approach and the Simplified Standardised Approach in relation to different types of assets that are used to calculate the Pillar 1 RWA for credit risk.
Standardised Approach Simplified Standardised Approach or SSA Basic Indicator Approach Alternative Standardised Approach	<p>These approaches are established in Pillar 1 of Basel II as acceptable methods of calculating capital requirements for credit, market and operational risk. Basel II allows regulators considerable discretion in implementing these approaches, especially in respect of the calculations for credit and operational risk. The JFSC has established the following variants as available in Jersey:</p> <ul style="list-style-type: none"> › the Standardised Approach and the Simplified Standardised Approach, or “SSA”, for credit risk; › the Standardised Approach, the Alternative Standardised Approach and the Basic Indicator Approach for operational risk; and › the Standardised Approach for market risk. <p>Detailed descriptions of these variants are provided on the JFSC’s website at: http://www.jerseyfsc.org/banking_business/reporting/index.asp</p>
SREP	The supervisory review and evaluation process is the assessment by a supervisor of a bank’s risks, risk mitigation and capital requirements, as reflected in its ICAAP documentation.
SRM	Supervisory Risk Model, used by the JFSC to evaluate the riskiness of a bank.

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Section 1: Introduction

1 Summary

- 1.1 This guidance note provides an overview of the expectations of the Jersey Financial Services Commission (**JFSC**) in respect of a Jersey incorporated registered deposit taker's internal capital adequacy assessment process (**ICAAP**) and the supervisory review and evaluation process (**SREP**) undertaken by the JFSC.
- 1.2 The JFSC does not impose capital requirements on branches, as the home regulator has primary responsibility for the overall capital adequacy of a legal entity and hence this guidance note is not relevant to such registered persons. Hereafter, references to "bank" relate solely to deposit takers that are registered and incorporated in Jersey.
- 1.3 The guidance note has three main aims:
 - 1.3.1 the provision of guidance on the ICAAP, including:
 - 1.3.1.1 best practice observed by the JFSC;
 - 1.3.1.2 the JFSC's views in respect of risks that are particularly relevant to Jersey banks;
 - 1.3.1.3 Basel Committee on Banking Supervision (**BCBS**) guidance in respect of Pillar 2, particularly stress testing and liquidity; and
 - 1.3.1.4 Financial Stability Board (**FSB**) guidance in respect of recovery planning, particularly reverse stress testing and early warning indicators;
 - 1.3.2 clarification of the JFSC's use of the ICAAP in its assessment of capital requirements; and
 - 1.3.3 clarification of the JFSC's expectations regarding the ongoing annual submission of revised ICAAP documentation.
- 1.4 The JFSC considers that it is appropriate to issue a revised Guidance Note to address recent developments. This encompasses changes in the operating environment (in particular, the international initiative to end too-big-to-fail) and the new international standards for bank recovery and resolution. The latter are contained within papers issued by the FSB, which is an international organisation tasked by the G20 (an international forum for the governments and central bank governors from 20 major economies) with developing standards concerning bank recovery and resolution.
- 1.5 The additional guidance is also intended to ease implementation of local proposals to establish a framework for bank resolution, by establishing an approach to recovery planning locally that is consistent with relevant standards. Further changes will be required once the legal framework is amended, such as to place relevant elements in the Code of Practice for Deposit-taking Business (**Banking Code**), which will build upon the guidance set out herein.

- 1.6 This Guidance Note should be read in conjunction with feedback provided by the JFSC in respect of individual ICAAPs and contingency planning, including guidance provided with respect to Liquidity Contingency Plans (LCPs)¹.
- 1.7 When compared to the previous Guidance Note “Pillar 2 in Jersey”, issued in July 2013 (the “2013 Guidance Note”), the main change is the creation of a new sub-section 9 (in Section 3), titled “Reverse stress testing and recovery planning” and related appendices providing additional guidance regarding this. These combine existing guidance on reverse stress testing with new guidance on recovery planning.
- 1.8 This revised guidance is applicable to all ICAAPs dated 1 October 2017 or later. Banks may opt to follow the revised guidance earlier.

2 Background

- 2.1 2005, the BCBS issued a paper entitled “International Convergence of Capital Measurement and Capital Standards” with the subtitle “A Revised Framework”. This documented a revised international standard for the calculation of banks’ minimum regulatory capital requirements. Both it and the final version published in June 2006 are referred to as “Basel II”.
- 2.2 Basel II comprises three Pillars, with Pillar 1 setting out minimum capital requirements in a manner analogous to Basel I. Pillar 2 sets out the supervisory review process and Pillar 3 establishes measures to make better use of market discipline. Pillar 3, as stated in Basel II (paragraph 822), applies only at the top consolidated level of a banking group and is therefore considered not to be applicable to Jersey banks.
- 2.3 Pillar 2 sets out a framework that both banks and supervisors should follow in the assessment of:
- 2.3.1 the full breadth of risks that each bank faces;
 - 2.3.2 the extent to which these are mitigated; and
 - 2.3.3 the level of additional capital, if any, that should be held to adequately cushion that net position.
- 2.4 The JFSC first addressed Pillar 2 within its paper “Basel II in Jersey: Reporting and Pillar 2”, issued in August 2007.
- 2.5 Since then, all banks have supplied documentation to the JFSC describing their ICAAP; the JFSC has reviewed these and agreed individual capital minima for each bank. During this period, the JFSC has developed its internal processes and considered best practice in respect of certain risks.
- 2.6 The BCBS has produced a number of papers on the principles of managing various risk categories, which the JFSC commends to all banks. Recently, it has issued several papers that address the extended market turmoil seen since mid-2007 and provide relevant guidance. These include:

¹ Appendix B to “Liquidity Management and Reporting”, issued May 2007 by the JFSC and available at: <http://www.jerseyfsc.org/pdf/liquidity%20management%20and%20reporting.pdf>

- 2.6.1 “Enhancements to the Basel II framework” (**Basel 2.5**), issued July 2009²;
 - 2.6.2 “Principles for Sound Stress Testing Practices and Supervision” (**BCBS stress testing paper**), issued May 2009³; and
 - 2.6.3 “Principles for Sound Liquidity Risk Management and Supervision”, issued September 2008⁴.
- 2.7 The FSB has produced a number of papers that, in the context of wider bank resolution considerations, establish principles for recovery planning, which the JFSC commends. These include:
- 2.7.1 “Key Attributes of Effective Resolution Regimes for Financial Institutions”⁵, issued in 2011 and reissued in 2014, and in particular KA 11 “Recovery and Resolution planning” and the related Annex on “Essential elements of recovery and resolution plans”⁶; and
 - 2.7.2 “Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Recovery Triggers and Stress Scenarios”⁷, issued July 2013.
- 2.8 These principles are considered to be generally relevant for banks when developing contingency plans and, where most relevant locally, are reflected in the guidance provided herein.

² Can be accessed at: <http://www.bis.org/publ/bcbs157.htm>

³ Can be accessed at: <http://www.bis.org/publ/bcbs155.htm>

⁴ Can be accessed at: <http://www.bis.org/publ/bcbs144.htm>

⁵ Can be accessed at <http://www.fsb.org/what-we-do/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions>

⁶ Can be accessed at <http://www.fsb.org/wp-content/uploads/l-Annex-4-Essential-elements-of-recovery-and-resolution-plans.pdf>

⁷ Can be accessed at http://www.fsb.org/wp-content/uploads/r_130716c.pdf

Section 2: Pillar 2 and the ICAAP

3 The JFSC's general approach to Pillar 2

- 3.1 Pillar 2, as described in Basel II, establishes the “supervisory review process”. Basel II states (paragraphs 721 and 722):
- 3.1.1 “The supervisory review process recognises the responsibility of bank management in developing an internal capital assessment process and setting capital targets that are commensurate with the bank’s risk profile and control environment. In the Framework, bank management continues to bear responsibility for ensuring that the bank has adequate capital to support its risks beyond the core minimum requirements.
 - 3.1.2 Supervisors are expected to evaluate how well banks are assessing their capital needs relative to their risks and to intervene, where appropriate. This interaction is intended to foster an active dialogue between banks and supervisors such that when deficiencies are identified, prompt and decisive action can be taken to reduce risk or restore capital. Accordingly, supervisors may wish to adopt an approach to focus more intensely on those banks with risk profiles or operational experience that warrant such attention.”
- 3.2 The JFSC has established that this will be specifically achieved, by:
- 3.2.1 each bank submitting a document setting out its ICAAP – the “ICAAP document”; and
 - 3.2.2 the JFSC reviewing each ICAAP document submitted, and:
 - 3.2.2.1 establishing a minimum risk asset ratio (**RAR**) for the bank that will either be equal to or exceed the JFSC’s minimum RAR, which is established in the Banking Code as being 10%;
 - 3.2.2.2 agreeing a “buffer RAR” level. The JFSC expects to be notified of any actual or predicted decline in a bank’s RAR that would lead to the buffer RAR being breached. Such notification should contain an explanation of the circumstances; and
 - 3.2.2.3 agreeing with the bank any other steps to be taken. This might include changes to risk management processes, specific additional capital requirements or the introduction of risk mitigation steps.

4 The ICAAP

- 4.1 The ICAAP is the process that a bank uses to assess its capital adequacy. The ICAAP document is a single document that explains the process from the viewpoint of the bank’s board, which should approve the document.
- 4.2 The board of each registered person bears the primary responsibility for ensuring the adequacy of its capital to support all risks incurred. The JFSC’s review of the ICAAP in no way detracts from, or replaces, this responsibility.
- 4.3 The ICAAP should include the bank’s assessment of its current risk profile plus expected and stressed outcomes over a reasonable period.

- 4.4 Paragraph 727 of Basel II states the five main features of a rigorous ICAAP are as follows:
- 4.4.1 board and senior management oversight;
 - 4.4.2 comprehensive assessment of risks;
 - 4.4.3 monitoring and reporting;
 - 4.4.4 internal control and mitigation review; and
 - 4.4.5 sound capital assessment.
- 4.5 The JFSC recognises the benefits of retaining flexibility in the methods to be used in assessing capital adequacy. It will seek to provide guidelines where relevant for individual banks.

5 The JFSC's expectations in respect of the ICAAP

- 5.1 A bank is expected to review its ICAAP annually, or more frequently in the event that there is a material change in the bank's risk profile. The JFSC expects that this review will lead to an updated ICAAP document being submitted to it within twelve months of the conclusion of the previous year's dialogue.
- 5.2 Unless the risk profile has materially altered, it is expected that this document will reflect an update of the previous year's submission to reflect financial results for the intervening period and changes to budgets. Where a bank's risk profile has changed to a material extent during the year, the JFSC will expect a thorough review to be evidenced in the ICAAP document.
- 5.3 Banks' business and risk profiles differ and the ICAAP should be proportionate to the size, nature and complexity of a bank's business. Hence, the JFSC does not wish to be prescriptive on the format in which an ICAAP should be submitted. The format shown in Appendix A to this paper may be convenient for banks as it covers most of the matters typically reviewed by the JFSC. However, other formats may be acceptable. Appendix A is largely unchanged from that provided in the JFSC's past papers on this subject
- 5.4 Requests have been received by the JFSC for guidance on the assessment of risks. This is provided in Section 3 re quantification and in Section 4 re key risks. This guidance is not prescriptive and not all elements or risks will apply to every bank.
- 5.5 The JFSC welcomes dialogue at any time with individual banks on all aspects of the ICAAP, particularly in the period before a submission is made.
- 5.6 Banks should confirm to the JFSC their target date for submission three months in advance of this. It is acknowledged that changing circumstances may require revisions to planned dates.

6 The Supervisory Review and Evaluation Process (the SREP)

- 6.1 The JFSC's SREP will normally be an annual process, conducted following the receipt of a bank's revised ICAAP document. An interim review may become appropriate if the risk profile is deemed to have materially changed. This should be supported by a revised ICAAP document.
- 6.2 The JFSC will assess the ICAAP document to establish whether the amount of capital identified is sufficient to support the risks faced by the bank. The JFSC expects to be able to

- conclude its SREP within one month of receipt and will write to the bank, setting out its initial response. This period may be extended if, as part of the review, meetings or further information are required to address any issues arising.
- 6.3 The JFSC will adopt a proportionate approach to its review. The intensity and depth of it will reflect the nature, scale and complexity of individual banks, as well as the extent to which the bank's risk profile has changed over the previous year.
- 6.4 The JFSC will seek to address risks that it considers to be inadequately mitigated. This may reflect a requirement for improvements in such mitigation, rather than necessarily involving an increase in capital. The JFSC will always seek the bank's agreement and input to any such proposals.
- 6.5 Capital requirements will always involve a minimum RAR, a buffer RAR and any particular capital treatment, such as capital deductions, to be applied. The minimum RAR will be established as a registration condition.
- 6.6 The JFSC will provide reasons for its decisions. The bank will normally be provided with an initial indication of the decision and allowed one month to respond to this.
- 6.7 The JFSC will fully address any response to the initial indication before issuing a Notice under Article 17A(1)(c) of the Banking Business (Jersey) Law 1991 in respect of the intended registration condition. The Notice issued at that time will allow for a further period of one month for appeal before the registration condition becomes effective.
- 6.8 The JFSC will not always increase the minimum RAR even if Pillar 2 risks are identified. This may be the case where:
- 6.8.1 in the case of credit, operational and market risk, the Pillar 2 risk capital requirement is not more than that required under Pillar 1, after applying the minimum RAR;
 - 6.8.2 the amounts are not material;
 - 6.8.3 other requirements are considered to be more appropriate, such as requiring deductions from capital; or
 - 6.8.4 a buffer is considered to be an adequate mitigant, taking into account the scale and nature of the risk and the JFSC's view of the bank's riskiness, as reflected in its score in the Supervisory Risk Model (**SRM**) maintained for each bank by the JFSC (see below).
- 6.9 The JFSC will, as part of its review, take account of any relevant information obtained from off-site reviews, on-site examinations, prudential returns, meetings, media coverage and other research. These all feed into the SRM. The score reflects a combination of the JFSC's assessment of the riskiness of the bank and an impact assessment but, for the purpose of the SREP, the former is the sole determinant.
- 6.10 Dependent upon the ICAAP/SREP processes, SRM scores are likely to indicate minimum RARs being established as follows:
- 6.10.1 "Low" rating - a minimum RAR of 10% would apply;
 - 6.10.2 "Medium" rating - the JFSC would possibly look to increase the minimum RAR to between 10% and 11%; and
 - 6.10.3 "High" rating – the minimum RAR is likely to be 11% or higher.

- 6.11 The JFSC will review the corporate governance framework around the ICAAP document and will pay particular attention to Board oversight and involvement, as well as responses to any issues raised by the JFSC during the review. It will also wish to consider the extent to which the capital assessment is used routinely within the bank for decision making purposes.

Section 3: Quantification of Risks

7 Overview

- 7.1 In evaluating capital requirements, banks should endeavour to apply a consistent approach on-going. Banks should articulate and conform to a single definition of how much capital is required in relation to risk levels. The BCBS has established as a standard that banks should have enough capital available to meet needs over a one year time horizon at the 99.9th percentile confidence interval. This is equivalent to saying that capital should be adequate to cover all losses 999 times out of every 1,000.
- 7.2 The JFSC appreciates that mathematical modelling may not be appropriate for all risk categories to determine such a 1 in 1,000 loss rate and considers that a realistic worst case loss may instead be appropriate.
- 7.3 If economic capital modelling techniques are used then banks are expected to use a default rate of 1 in 1,000.
- 7.4 Banks' assessments are expected to be forward looking, assessing the impact over an extended period that is appropriate for the bank but which is expected to be typically at least three years. This assessment should document both the impact of perceived risk levels on capital requirements and the impact of other expectations, including budgeted profits, capital raising plans and dividends.
- 7.5 The assessment should cover three factors:
- 7.5.1 baseline: a baseline forecast should be provided, showing how key drivers and the risk asset ratio are expected to evolve over the three year period;
 - 7.5.2 stress scenarios: where scenarios are used, the impact should be evaluated over a similar period to the baseline forecast; and
 - 7.5.3 risk events: the impact of risk events should be determined after taking into account forecast changes in the bank's risk profile.
- 7.6 Every assessment should result in a determination of the amount of capital required to meet the residual risk. Where relevant, this should be compared to the amount required under Pillar 1 (see sub-section 12 in Section 3). For the avoidance of doubt, this should be determined for each risk and for the bank as a whole.
- 7.7 Whilst it is recognised that banks do not always forecast financial performance three years ahead, it is still important that the ICAAP addresses how the bank can maintain its capital at adequate levels relative to changing risk profiles. Banks should therefore endeavour to develop a three year forecast baseline for the purpose of the ICAAP, noting any caveats that apply and addressing the uncertainty associated with them.
- 7.8 Banks may consider diversification and correlation when combining risks. Any assumptions should be stated in the ICAAP document, with the JFSC expecting that, in most cases, the worst case total risk capital will fall between the gross total of all the individual risks and an amount that would be arrived at by assuming all risks are uncorrelated. However, Pillar 1 charges must be applied on a gross basis.

- 7.9 Banks should assess the potential for capital shortfalls arising and record likely methods for addressing these, such as the cancellation of dividends. Such plans should set out the triggers for action and contain comprehensive detail of the contingency plan. This should include addressing the consequences of the action and any likely impediments to the action, such as requirement for group / shareholder / JFSC approval.
- 7.10 Where contingency plans rely on capital being made available by Group, sufficient detail should be provided in the ICAAP to demonstrate that the amounts relied upon actually would be made available in the circumstances contemplated. Where commitments are contingent on future actions, or barriers exist, the processes involved should be explained and timelines set out. Where significant barriers are identified, the bank should consider alternatives, such as maintaining higher buffers, or other measures that would reduce capital requirements.
- 7.11 The ICAAP should contain a summary that considers the baseline, relevant scenarios and risk events and which arrives at an estimation of the capital requirements, comprehensively calculated for each period, and compares this to both the forecast regulatory capital requirement and the forecast amount of available capital. Where shortfalls are identified, the capital planning part of the ICAAP should explain how and when capital would be raised.

8 Stress testing

- 8.1 Banks are expected to have in place appropriate stress testing processes. These should form an integral part of the governance and risk management culture of a bank and should be reflected in its ICAAP. Banks need to be aware of relevant BCBS papers, including the BCBS stress testing paper.
- 8.2 Banks that have had the use of Advanced Approaches approved by the JFSC should note that the above is in addition to the stress testing that must be undertaken specifically in relation to such approaches, as set out within Basel II (and in the case of market risk, as set out in “Revisions to the Basel II market risk framework”⁸, issued by the BCBS in July 2009).
- 8.3 A standard list of stress tests is shown in Appendix B. These are not obligatory but should be considered for inclusion where the related risk is material.
- 8.4 Stress test results should not be focussed solely on capital but should evaluate the impact of the stress on a wider range of measures, such as liquidity and profitability. In particular, banks that have agreed liquidity behavioural adjustments with the JFSC are expected to conduct appropriate stress testing to enable an assessment of the continuing appropriateness of those adjustments.
- 8.5 The stress testing programme should take account of views from across the organisation and should cover a range of perspectives. In particular, the aspects considered would be expected to include:
- 8.5.1 the identification of relevant stress events;
 - 8.5.2 identification of the extent of the impact of each event;
 - 8.5.3 appropriate modelling approaches; and

⁸ Can be accessed at: <http://www.bis.org/publ/bcbs158.htm>

- 8.5.4 appropriate use of stress testing results.
- 8.6 Banks should regularly maintain and update their stress testing frameworks, and this should be reflected in the ICAAP.
- 8.7 Commensurate with the principle of proportionality, stress tests should be geared toward the most material business areas and events that might be particularly damaging for the bank. This could include not only events that inflict large losses but also those that cause damage to the bank's reputation. As part of the overall stress testing programme, it is important to include some extreme scenarios which would cause the bank to be insolvent (i.e. stress events which threaten the viability of the bank). If a stress test is based on a probability of other than 1 in 1,000, the recorded level of risk may be scaled to reflect this.
- 8.8 Stress test scenarios should be sufficiently detailed to enable the bank to demonstrate that it has fully considered all impacts. As an example, an ICAAP that includes an assessment of the impact of a severe recession on the bank's customers should also explain the expected impact on its own parent and group (and the consequent impact on counterparty risk).
- 8.9 A single stress event may lead to multiple possible outcomes and stress testing should explore those that give the worst outcome for the bank, including the impact of management action. For example, a credit rating downgrade of a parent bank might impact the local subsidiary's ability to attract deposit customers. This could be modelled as a decrease in the margin received on new business or a reduction in levels of new business. Whilst the latter may have an impact on capital generation, it might be the case that the former leads to a greater impact on capital adequacy as it leads to both lower capital generation and higher capital requirements as a higher level of deposits is retained.
- 8.10 Stress scenarios should be sufficiently detailed with respect to outcomes over time. Immediate impacts clearly need to be assessed but consideration also needs to be given to how they might lessen over time.
- 8.11 Where mitigating action is considered to be an appropriate alternative to holding extra capital, the impact of this should be shown separately i.e. the ICAAP should identify the impact of an event (without any mitigating action) then the impact of the mitigating action. The description of the scenario should provide details of both the mitigating action and the triggers for this.
- 8.12 The JFSC would expect a bank to act in line with documented action plans in the event that forecast events materialised. The ICAAP should provide a clear indication of how management monitors risks to identify such events.

9 Reverse stress testing and recovery planning

- 9.1 The 2013 Guidance Note stated that banks should include reverse stress tests that seek to determine what scenarios could challenge the viability of the bank and thereby uncover hidden risks and interactions among risks, and also that it is important to include scenarios which could cause the bank to be insolvent (i.e. stress events which threaten the viability of the bank).
- 9.2 Given the importance of such stress testing, it is suggested that this should be documented in a separate section within the ICAAP. A range of reverse stress test scenarios should be described and the efficacy of the bank's contingency plans should be examined. There should

typically be two to four scenarios and include both systemic and idiosyncratic (bank only) stresses. Further guidance is provided in Appendix C.

- 9.3 The ICAAP should include a section on the bank’s recovery plans, including sufficient detail on its contingency plans to enable demonstration of how they would help to restore capital adequacy and maintain liquidity or otherwise mitigate the impact of stresses on the bank and its customers. With respect to liquidity, this could be by reference to its Liquidity Contingency Plan (**LCP**). Whatever format is used:
- 9.3.1 production should take into account guidance issued by the JFSC on the LCP⁹; and
 - 9.3.2 the recovery plan in the ICAAP could be used in place of a separate LCP.
- 9.4 The recovery planning coverage in the ICAAP should:
- 9.4.1 describe in sufficient detail the range of credible potential actions identified by the bank, which should include an assessment of the likely positive and adverse consequences;
 - 9.4.2 identify “recovery triggers” that would prompt consideration of management action. Further guidance is provided in Appendix D;
 - 9.4.3 establish for each potential management action the factors relevant to carrying it out, including (1) identification of responsibilities for considering and implementing each action, (2) identifying and addressing any barriers to actions, including the need for external stakeholder approval and the likely timescale for such action to commence or have effect, (3) communication, including with the JFSC and other regulatory authorities and (4) assessment of the credibility of each potential action. Further guidance is provided in Appendix E; and
 - 9.4.4 establish responsibilities for recovery planning, starting with the Board.
- 9.5 The reverse stress tests should be used to demonstrate the efficacy of such plans and highlight residual risks.
- 9.6 Banks are not expected to identify or hold additional capital or liquidity for such risks. However, where recovery planning indicates a potential need for capital under particular scenarios, plans should identify the mechanisms for the provision of capital, including identifying recovery triggers that would result in such actions, identifying barriers, timescales and considering contractual arrangements required to facilitate this.
- 9.7 Banks are expected to be aware of group recovery plans and may be informed by relevant considerations but ultimately the responsibility for development rests with the Board of the local bank.

10 Use of risk models

- 10.1 If a bank uses models, the ICAAP document should provide an overview of these, including the assumptions underlying them, and explain the key drivers. Models used should be appropriate for the local entity and banks are expected to sense check results.

⁹ Appendix B to the Guidance Note “Liquidity Management and Reporting”, issued May 2007, available at <http://www.jerseyfsc.org/pdf/liquidity%20management%20and%20reporting.pdf>

- 10.2 The bank should explain the steps it has taken to validate models used, which should include regular review.
- 10.3 Group models may be used, if applicable to local circumstances, but are subject to the above requirements.

Section 4: Risk Guidance Notes

11 Overview

11.1 The full range of material risks faced by a bank will vary from one bank to another, dependent upon such factors as the customer base, operational complexity, market activities and outsourced functions. It remains a bank’s responsibility to comprehensively identify, measure, control and adequately mitigate all risks of significance that it faces and to maintain sufficient capital to reflect that overall risk position.

11.2 In general, there are four categories of risks that should be considered in a bank’s ICAAP:

- 11.2.1 Category one: Risks covered by Pillar 1 capital requirements;
- 11.2.2 Category two: Risks only partially covered by Pillar 1 capital requirements;
- 11.2.3 Category three: Risks not covered by Pillar 1; and
- 11.2.4 Category four: External factors.

11.3 Categories one, two and three are mainly concerned with current risks and unexpected events or losses.

11.4 Category four considers the outcome of forward capital planning for the first three elements, in which stress-testing may play a key role.

11.5 Components of the four categories include, but are not limited to:

Category one	Risks covered by Pillar 1 capital requirements	<ul style="list-style-type: none"> › Credit risk › Market risk › Operational risk
Category two	Risks only partially covered by Pillar 1 capital requirements	<ul style="list-style-type: none"> › Residual risk › Counterparty credit risk › Securitisation risk › Model risk › Underestimation of credit, market or operational risk in Pillar 1 › Parent risk
Category three	Risks not covered by Pillar 1	<ul style="list-style-type: none"> › Strategic risk › Concentration risk › Liquidity risk › Reputation risk › Interest rate risk in the banking book › Settlement risk › Underwriting risk › Pension risk › Transfer risk › Weaknesses in credit risk mitigation
Category four	External Factors	<ul style="list-style-type: none"> › Business risk (earnings and costs) › Strategy › Economic environment › Regulatory environment

- 11.6 The above list of risks is not definitive – a bank must identify its key risks for itself. The table is solely an aid to assist in this process but guidance is given below on certain of these risks, which should be considered where applicable.
- 11.7 Appendix 1 “Risk Management Controls” to the Banking Code provides further relevant guidance. Additionally, specific risk guidance is issued by the JFSC from time to time. Banks are recommended to remain cognisant of all relevant “sound practice” papers issued by the BCBS on the management of risk.
- 11.8 Further guidance is provided on the following risks within this Section:
- 11.8.1 credit risk, market risk and operational risk (sub-section 12);
 - 11.8.2 residual risk (sub-section 13);
 - 11.8.3 counterparty credit risk (sub-section 14);
 - 11.8.4 underestimation of credit, market or operational risk in Pillar 1 (sub-section 15);
 - 11.8.5 concentration risk (sub-section 16);
 - 11.8.6 credit risk: ratings migration risk (sub-section 17);
 - 11.8.7 credit risk: exposure to parent/group entities (sub-section 18);
 - 11.8.8 market risk: structural foreign exchange risk (sub-section 19);
 - 11.8.9 market risk: asset price risk (sub-section 20);
 - 11.8.10 liquidity risk (sub-section 21);
 - 11.8.11 interest rate risk in the banking book (sub-section 22);
 - 11.8.12 pension risk (sub-section 23);
 - 11.8.13 strategic risk (sub-section 24);
 - 11.8.14 reputational risk (sub-section 25);
 - 11.8.15 parent risk (sub-section 26); and
 - 11.8.16 regulatory risk (sub-section 27).

12 Credit risk, market risk and operational risk

- 12.1 Banks should use Pillar 1 methodology for initial capital calculations in respect of credit risk, market risk and operational risk.

13 Residual risk

- 13.1 Whilst banks use credit risk mitigation (**CRM**) techniques to reduce their credit risk, these techniques may themselves give rise to risks that then limit actual overall risk reduction. These additional risks include legal risk, documentation risk, counterparty risk and liquidity risk. Banks should have in place appropriate written CRM policies and procedures in order to control these residual risks. Banks may be required to submit these policies and procedures to the JFSC and should regularly review their appropriateness, effectiveness and implementation.

14 Counterparty credit risk (CCR)

- 14.1 Banks should have a process in place for ensuring compliance with a documented set of policies, controls and procedures covering CCR.
- 14.2 Such policies, controls and procedures should be conceptually sound and implemented with integrity relative to the sophistication and complexity of a bank's CCR exposures. A sound CCR management framework should include the identification, measurement, management, approval and internal reporting of CCR.
- 14.3 Banks' risk management policies must take account of the market, liquidity, legal and operational risks that can be associated with CCR and the inter-relationships among those risks. Banks should not undertake business with a counterparty without assessing its creditworthiness, where applicable, and should take account of both settlement and pre-settlement credit risk. These risks should be managed as comprehensively as is practical at the counterparty level (aggregating counterparty exposures with other credit exposures) and at the bank-wide level.
- 14.4 A bank's board of directors should be actively involved in the CCR control process and should apply appropriate focus on this, with adequate resources allocated to it. Reports prepared on a bank's exposures to CCR should be reviewed by a level of management with sufficient seniority and authority to enforce, when necessary, both reductions of positions taken by individual credit managers or traders and reductions in the bank's overall CCR exposure.
- 14.5 The measurement of CCR should include both daily and intra-day monitoring of the usage of credit lines. The bank should measure current exposures both gross and net of collateral held. Account should be taken of large or concentrated positions, including concentrations by groups of related counterparties, by industry, by market and by customer investment strategies.

15 Underestimation of credit, market or operational risk in Pillar 1

- 15.1 For the avoidance of doubt, this occurs where the amount of capital required, as determined under Pillar 2, exceeds the amount required under Pillar 1; 10% of RWAs. Offsets between these risk categories are not allowed; each of the three risk categories must be considered alone.
- 15.2 The increment required is the amount by which the Pillar 2 calculation exceeds the Pillar 1 capital charge. For example, if the internal assessment of credit risk indicated that £11 million of capital was required and the bank had Pillar 1 RWAs of £100 million, then the underestimation would be £1 million under Pillar 2, based on the minimum RAR in Jersey of 10%. (In passing, please note that the higher minimum RAR in Jersey, compared to the minimum in Basel II, has the effect of lessening the likelihood and degree of underestimation. In the example used, a similar bank that had a minimum Pillar 1 RAR of 8% would have an underestimation amounting to £3 million under Pillar 2).
- 15.3 Several examples are given below of circumstances where the Pillar 1 process may not adequately estimate all risk, but this is by no means an exhaustive list of such circumstances.
- 15.4 Credit risk: simplified standardised approach (SSA)

- 15.4.1 Banks that use the SSA for credit risk should consider the impact if, instead, the standardised approach was applied.
- 15.4.2 In this case, the risk of potential underestimation of credit risk arises from two aspects of the SSA in particular:
- 15.4.2.1 external credit ratings information, whilst not perfect, is relevant information that is not taken into account in the SSA; and
 - 15.4.2.2 in respect of both bank and sovereign exposures, reliance on OECD country weightings in the simplified standardised approach may not reflect all factors relevant to the riskiness of the exposures.
- 15.5 Credit risk: indicative facilities
- 15.5.1 Some banks have adopted the practice of giving indicative credit facilities to clients on an uncommitted basis. Such clients are often significant corporate customers. Commercially, a bank may not wish to walk away from such arrangements and relationships; the credit risk of such uncommitted facilities therefore needs to be recognised. It is important to estimate the realistic potential exposure to the counterparty (not just the contractual exposure) and ensure that sufficient capital is available to cover that risk.
- 15.6 Operational risk
- 15.6.1 Operational risk is defined by the BCBS as “the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.”
- 15.6.2 Gross income, used in the Basic Indicator and Standardised Approaches for calculating operational risk, and book size, used in the Alternative Standardised Approach, are only proxies for the scale of operational risk exposure of a bank. This can underestimate the need for capital to cover operational risks. Drawing on the BCBS document “Principles for the Sound Management of Operational Risk”, issued in June 2011, a bank should consider whether the capital requirement generated by the Pillar 1 calculation gives an adequate picture of its operational risk exposure, for example by comparison with the bank’s experience of operational losses. The JFSC, in its review of this area, will make relevant peer comparisons.
- 15.6.3 The development of methodologies for the quantification of operational risk is at an early stage when compared to progress made in respect to credit and market risk. Locally, progress has been seen since the introduction of Pillar 2 in 2008, focussing initially on the identification of key elements of operational risk and progressing towards the assessment of these through the use of scenario and stress testing.
- 15.6.4 The JFSC has not developed a view as to the best way of combining individual scenario results to arrive at a capital requirement but considers that simple, transparent methods that relate the results of individual scenarios to the charge required under the standardised approaches within Pillar 1 are more easily workable than complex modelling.
- 15.6.5 If a bank considers switching to the Advanced Measurement approaches for Pillar 1, it is accepted that this will result in the use of more complex models but the bank must demonstrate that capital is appropriate for local conditions and achieve transparency in Pillar 2 calculations.

- 15.6.6 Banks that have identified specific operational risks, such as mis-selling, should consider whether these warrant additional capital or other risk mitigation. This is particularly relevant for banks registered to conduct other financial service business, which should consider the degree to which professional indemnity insurance (PII) cover mitigates risk arising from these activities.
- 15.6.7 Banks that are registered to conduct business for which the JFSC has established PII requirements should detail the PII cover held in the ICAAP document. Those banks that have obtained an exemption in this respect should set out the alternative arrangements agreed, including details of any self-insurance, group cover or capital set aside. In such cases, the ICAAP should consider the efficacy of such arrangements. The starting point for the capital requirement should be the level of PII cover required, with the proviso that this may be lowered where it can be demonstrated that the alternative provisions made would be effective, such as if group (formally) underwrites this risk.
- 15.6.8 With respect to legal risk, a bank facing a lawsuit might not have provided for it in its accounts as it expects to win the case, but it may be appropriate to make allowance in its ICAAP, this being its estimated realistic worst case outcome.
- 15.7 Use of advanced approaches
- 15.7.1 As noted in sub-section 8 in Section 3, stress testing is required in connection with the use of advanced approaches, as set out in Basel II and “Revisions to the Basel II market risk framework”.

16 Concentration risk

- 16.1 A risk concentration is any single exposure or group of related exposures with the potential to produce losses large enough to significantly impact upon a bank’s financial health or ability to maintain its core operations.
- 16.2 Risk concentrations are arguably the single greatest cause of major problems incurred by banks. Credit risk concentration arises both in direct exposures to obligors and through exposure to protection providers. Such concentrations are not addressed in the Pillar 1 capital charge for credit risk.
- 16.3 The typical situations in which risk concentrations can arise include:
- 16.3.1 exposures to a single counterparty, borrower or group of connected counterparties or borrowers (the JFSC has long established requirements for “Large Exposures”¹⁰);
 - 16.3.2 industry or economic sectors, including exposures to both regulated and non-regulated financial institutions such as hedge funds and private equity firms;
 - 16.3.3 geographical regions (or in combination with the above, an example of which might be the UK banking sector);
 - 16.3.4 exposures arising from CRM techniques, including exposure to similar collateral types or to a single or closely related credit protection provider;
 - 16.3.5 trading exposures/market risk;

¹⁰ The Banking Code contains detailed requirements in respect of Large Exposures, which are underpinned by the Banking Business (General Provisions) (Jersey) Order’s requirement for the JFSC’s approval to be sought in respect of all exposures in excess of 25% of capital.

- 16.3.6 exposures to counterparties (e.g. hedge funds and hedge counterparties) through the execution or processing of transactions;
 - 16.3.7 funding sources;
 - 16.3.8 assets that are held in the banking book or trading book, such as loans, derivatives and structured products; and
 - 16.3.9 off-balance sheet exposures, including guarantees and liquidity lines.
- 16.4 A bank's framework for managing credit risk concentrations should be clearly documented and include definitions of the credit risk concentrations relevant to the bank and how these concentrations and their corresponding limits are calculated. Limits should normally be defined either in absolute terms or in relation to a bank's capital.
- 16.5 In accordance with the Banking Code, banks are recommended to adopt appropriate risk management standards established within the BCBS document "Principles for the Management of Credit Risk", issued in September 2000.
- 16.6 Banks should have in place effective internal policies, systems and controls to identify, measure, monitor, manage, control and mitigate its risk concentrations in a timely manner. Not only should normal market conditions be considered, but also the potential build-up of concentrations under stressed market conditions, economic downturns and periods of general market illiquidity. In addition, banks should assess scenarios that consider possible concentrations arising from contractual and non-contractual contingent claims. The scenarios should also combine the potential build-up of pipeline exposures together with the loss of market liquidity and a significant decline in asset values.
- 16.7 Banks should explicitly consider the extent of their credit risk concentrations and explain how their credit risk policies cover the most material forms of credit risk concentrations to which a bank may be exposed.
- 16.8 A bank should conduct periodic stress tests of its major risk concentrations and review the results of those tests to identify and respond to potential changes in market conditions that could adversely impact the bank's performance.
- 16.9 The JFSC will assess the extent to which a bank considers its risk concentrations in its ICAAP and how they are mitigated. Such assessments should include reviews of the results of any stress tests carried out, either locally or at group level.
- 16.10 For most banks, the largest exposures will be to parent, or group-bank exposures (sister companies). The ICAAP should consider the concentration risk posed by these exposures. See also sub-section 25 "Parent risk" for further guidance regarding the assessment of this risk.
- 16.11 The JFSC's Large Exposure requirements were amended, with effect from April 2013, to require that Concession Limits, based on formal credit assessment of group counterparties, should be established for all up-streaming. These credit assessments should be summarised within the ICAAP. Concession Limits are approved subject to at least an annual review being undertaken and it is suggested that the review material be provided to the JFSC with the ICAAP so that both exercises can proceed based on analysis of the same risk data.

17 Credit risk: ratings migration risk

- 17.1 The Pillar 1 RWA is calculated using risk weightings that are dependent on credit ratings. For the Standardised and Simplified Standardised Approaches, these are the credit ratings assigned to counterparties by eligible external credit assessment institutions (currently Moody's, Standard & Poor's and Fitch), whereas for Advanced Approaches, internal credit ratings are generated by internal models.
- 17.2 Banks should identify the key risks arising from this and the impact of a realistic worst case, which may include:
- 17.2.1 the downgrade of sovereigns, including the country of incorporation of bank counterparties; and
 - 17.2.2 the downgrade of rated counterparties.
- 17.3 Whilst the impact on the weighting is the most direct and obvious impact, banks should also consider the impact on the price of bonds held and thence on capital, either as a result of a potential sale or via fair value accounting.

18 Credit risk: exposure to parent / group entities

- 18.1 In Jersey, exposures to parent / group entities are the largest source of credit risk in Pillar 1. Banks' Pillar 2 assessments of credit risk, including in respect of concentration risk and ratings migration risk, should separately identify this exposure from other credit exposures.

19 Market risk: structural foreign exchange risk

- 19.1 Foreign exchange risk assessments should include an assessment of structural foreign exchange risk, as well as trading foreign exchange risk.
- 19.2 The Pillar 1 requirement includes positions arising from both trading activities and from holding capital in foreign currencies, including profits and losses booked in foreign currencies. The ICAAP should provide the bank's assessment of the impact of adverse foreign exchange movements, including:
- 19.2.1 the direct impact on capital due to the revaluation of any foreign currency position; and
 - 19.2.2 the impact on capital requirements of the revaluation of assets held in foreign currencies.
- 19.3 Assessments are expected to look at structural foreign exchange risk separately from any trading foreign exchange risk.
- 19.4 For many Jersey banks, capital adequacy is only materially impacted by exchange rates where capital is held in a different currency to some assets (**structural foreign exchange risk**). This applies where the capital is held in a foreign currency (i.e. not the accounting currency of the bank) and/or assets (and hence risk weighted assets) are held in a foreign currency.
- 19.5 In most cases, it is the assets that are denominated in foreign currencies. This gives rise to the risk that a currency movement triggers an increase in (usually) the sterling value of risk assets beyond planned levels. In many ways, this is similar to a situation where a bank grows

its balance sheet unexpectedly fast. Where applicable, banks should have contingency plans in place to address such a situation, with perhaps a capital buffer in place to address the immediate impact. However, ICAAPs do not always explain how such situations would be managed. Often, an explanation is given as to what the bank would do if lending growth caused risk assets to exceed targets but the situation where exchange rate moves caused this is overlooked.

19.6 The JFSC recognises that capital held in a foreign currency may act as a hedge against the revaluation of assets held in that currency and may allow the Pillar 1 charge to be reduced in such circumstances. In considering this, the JFSC is cognisant of Basel II, para 718(xxxviii), which states:

19.6.1 “...any positions which a bank has deliberately taken in order to hedge partially or totally against the adverse effect of the exchange rate on its capital ratio may be excluded from the calculation of net open currency positions, subject to each of the following conditions being met:

19.6.1.1 such positions need to be of a “structural”, i.e. of a non-dealing, nature (the precise definition to be set by national authorities according to national accounting standards and practices);

19.6.1.2 the national authority needs to be satisfied that the “structural” position excluded does no more than protect the bank’s capital adequacy ratio; and

19.6.1.3 any exclusion of the position needs to be applied consistently, with the treatment of the hedge remaining the same for the life of the assets or other items.”

19.7 In light of the above, the JFSC is prepared to allow the exclusion of that part of any capital that acts as a hedge in the reporting of foreign exchange positions in the prudential return, providing that the ICAAP adequately documents the hedges and a copy of the relevant policy is provided.

20 Market risk: asset price risk

20.1 The JFSC expects banks to address the impact of market prices, including in circumstances where assets are held at amortised cost for the purpose of determining regulatory capital. This would be expected to include the current scale of unrealised losses and the impact on stress tests of any sales of these assets or required future impairment under those stress tests.

21 Liquidity risk

21.1 The JFSC considers the following to be key to addressing liquidity risk:

21.1.1 measurement and monitoring of net funding requirements;

21.1.2 measurement of actual behaviour of depositors and the assessment of the impact of such behaviour on net funding requirements;

21.1.3 assessment of how other risks (e.g. credit, market and operational risk) may impact liquidity;

21.1.4 regular review of underlying assumptions;

- 21.1.5 adequate contingency planning, to cover both temporary and longer-term disruptions;
 - 21.1.6 specific application of the above to all material currency exposures; and
 - 21.1.7 appropriate internal control processes.
- 21.2 The BCBS paper “Principles for Sound Liquidity Risk Management and Supervision”, issued in September 2008, provides relevant guidance regarding liquidity risk, including in particular, relevant guidance on the establishment and maintenance of adequate stress testing..
- 21.3 Banks should also consider and comply with the “Liquidity Management and Reporting” guidance notes issued by the JFSC in May 2007.
- 21.4 Many of the scenarios developed for ICAAPs in respect of capital requirements are likely to lead to an impact on liquidity risk. Banks should therefore, when developing scenarios generally, seek to identify these in addition to capital, as well as considering liquidity risk specific scenarios. The reverse is also true; liquidity stress testing and scenario analysis, whilst primarily performed in order to identify and quantify the impact of future liquidity stresses, should also assess the impact on the institution’s profitability and solvency.
- 21.5 This is particularly important when identifying necessary mitigating actions; these should aim to ensure that the bank remains liquid as well as maintaining required minimum capital levels.
- 21.6 Reverse stress tests in respect of liquidity should be developed. These should include events that very significantly reduce available sources of liquidity (e.g. the failure of markets and of the parent to repay funds when due) as well as increased cash outflows. In considering such stresses, a bank should seek to identify how timely mitigating actions could reduce the impact and what should trigger such action (diversification of liquidity inflows/assets being the most commonly identified mitigant).
- 21.7 In addressing the management of liquidity risk, the ICAAP is expected to be consistent with the bank’s Liquidity Management Policy (**LMP**), Liquidity Contingency Plan (**LCP**), and the most recent review of the bank’s behavioural adjustments. It is recommended that copies of the LMP and LCP are provided with the ICAAP if they have changed since the last ICAAP submission.
- 21.8 Where behavioural adjustments are used, reviews should take place annually to ensure the continued appropriateness of them. A summary of the outcome should be provided with, or in, the ICAAP document. This may be by reference to the outcome of the latest internal review provided that:
- 21.8.1 the review is still current;
 - 21.8.2 key outcomes are summarised in the ICAAP; and
 - 21.8.3 a copy of the review is made available to the JFSC on request.

22 Interest rate risk in the banking book

- 22.1 The JFSC is of the view that, if the risk reported as part of the Prudential Return exceeds 5% of capital, this category should be specifically addressed within the ICAAP document. Where that risk approaches 20% of capital, enhanced mitigation is likely to be required.

- 22.2 It is recognised that the standardised 2% interest rate shock measure that forms part of the Market Risk reporting in the Prudential Return may overstate risk and that losses will typically impact earnings rather than capital. It is expected that assessment of interest rate risk in the ICAAP will be based on long term scenarios, looking at both worst case increases and decreases in interest rates and take into account the impact of margin compression in low interest rate scenarios. Specific guidance on scenarios is contained within Appendix B.

23 Pension risk

- 23.1 Pension risk is the risk of pension funding arrangements not being adequate to meet pension payment obligations. Subsidiaries with locally funded defined benefit pension schemes will need to take account of their risks in this area, including both current and potential shortfalls, and the impact that these might have on their capital. Many Jersey banks operate such schemes, although these are now mainly closed to new members.
- 23.2 Pillar 1 prudential reporting requirements require that any pension deficit should be deducted from capital or, alternatively, that additional funding agreed with the pension trustees as being necessary to close any deficit within the next five years should be deducted.
- 23.3 Risk assessments should consider the likely scale of deficits and the consequential capital impacts arising from stressed assumptions of the market values of pension fund assets, future returns on those assets and changing life expectancy levels.
- 23.4 Unless there is a general agreement regarding the funding of emergent deficits, it should be assumed that at least 50% of any deficit that arises as a result of stressing assumptions for the purpose of the ICAAP, would be required to be met with additional funding provided within five years

24 Strategic risk

- 24.1 Strategic risk is the current or prospective risk to earnings and capital arising from changes in the business environment and from adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment. As such, it is a forward looking measure and, as a minimum, the bank should consider whether its current strategy will lead to increased capital requirements within the period considered and how these will be addressed.

25 Reputational risk

- 25.1 Reputational risk (to financial institutions and to the jurisdictions from where they operate) is clearly a significant risk to be captured under Pillar 2 and is one of the most significant risks in offshore finance centres.
- 25.2 The JFSC expects banks to have assessed the reputational risk contained in its higher risk customer accounts and relationships and, where appropriate, to have used a proxy (which might be the number or proportion of high risk accounts or relationships a bank has on its books) to generate a capital charge for reputational risk and/or provide evidence of measures in place to mitigate that reputational risk. An example of such measures could be robust and clear customer acceptance procedures and implemented processes, with no “blind spots” (which includes inappropriately pooled accounts).

- 25.3 In considering reputational risk, a bank should have regard for the impact of reputational damage on other group entities and Jersey, in addition to itself.
- 25.4 Individual products and services should also be considered and assessed. The JFSC is of the view that tax based lending structures which lack any underlying commercial validity are of particular concern and warrant very full consideration.

26 Parent risk

- 26.1 Whilst many of the foregoing risks are connected with exposures to and supported by parent, in most banks' cases, the importance of the parent's financial strength is such that it should be addressed separately in the ICAAP, including the ability of the parent to provide support, both in terms of capital and liquidity, and, for many Jersey banks, the risk arising from the direct counterparty exposure to the parent through up-streaming.
- 26.2 The ICAAP should assess each significant risk and the potential actions that could mitigate these. It should identify risk levels that the bank is comfortable with and, as a natural corollary of this, also identify the mitigating actions that it would take if risk levels increased beyond those.
- 26.3 As an example, one scenario might involve risk weighted assets relating to up-streaming increasing when the credit rating of the counterparty fell. Mitigating actions could include shortening the tenor of deposits placed with parent (where this would lead to a lower risk weighting), increasing capital or seeking to reduce up-streaming levels. Stress testing should identify both the immediate and longer term impacts, without any mitigating action, and the impact of mitigating action. The description should cover the events that could trigger the need for mitigating actions, including objective criteria, such as deterioration in relevant credit ratings.
- 26.4 Given the criticality of this risk, an appropriately wide range of events and severity should be considered when designing related stress tests, including parental downgrades and reverse stress testing. The JFSC considers that most Jersey banks would usually not survive a sudden parent failure but that contingency plans should identify relevant warning signs, providing time for the bank and authorities to undertake appropriate mitigating action to ameliorate the impact of foreseeable events.
- 26.5 In assessing risks, banks should consider relevant legislation regarding bank resolution (including any that it is anticipated might come into force within the period covered by the ICAAP). In particular, banks must consider whether the following might apply to parental exposures:
- 26.5.1 subordination to retail depositors (directly or via depositor protection scheme preference); and
 - 26.5.2 "bail-in" powers that might allow the exposures to be written down or converted to equity.
- 26.6 The ICAAP should take into account recovery plans of the bank and its group to the extent that these might impact the bank or group counterparties.
- 26.7 It should also consider factors relevant to resolution plans for the group as a whole and individual group counterparties, to the extent that they are known, which should include

considering the potential for write-down or conversion of any relevant exposures and the circumstances where this might occur.

27 Regulatory risk

- 27.1 Regulatory risk encompasses both compliance with existing regulations and the risk posed by changes in the regulatory environment.
- 27.2 Consideration of the latter should focus on those changes that would have a material impact on the business, whether directly or indirectly. The ICAAP should identify possible impacts and how these could be mitigated. Areas of change could include proposals by the JFSC, group regulators, the States of Jersey, overseas governments, the Basel Committee and other international standard setters.
- 27.3 The ICAAP should contain an overview of the bank's Business Risk Assessment (a regulatory AML/CFT requirement), highlighting any changes in this since the last ICAAP. This provides a context for consideration of reputational and operational risks.

Appendix A: ICAAP Submission – a Format That May Be Used

XYZ Bank Ltd

Below is an outline of a suggested format showing the general areas and headings an ICAAP could take:

1 Executive summary

- 1.1 The purpose of the Executive Summary is to present an overview of the ICAAP methodology and results. This overview would typically include:
 - 1.1.1 the purpose of the ICAAP;
 - 1.1.2 the main findings of the ICAAP such as :-
 - 1.1.2.1 how much and what composition of capital the bank considers it should hold in addition to the Pillar 1 minimum capital requirement; and
 - 1.1.2.2 a description of the bank's overall risk management processes, including comments on their adequacy;
 - 1.1.3 key financial commentary, including a summary of the bank's balance sheet strength, strategy and likely future profitability;
 - 1.1.4 brief descriptions of the capital and dividend plan;
 - 1.1.5 commentary on the bank's most material risks, why the level of risk is considered acceptable or, if it is not, what mitigating actions are planned; and
 - 1.1.6 who has carried out the assessment, how it has been challenged, and who has approved it.

2 Background

- 2.1 This section would cover relevant organisational and historical financial data on the bank such as group structure, key data and trends. It would include any conclusions that can be drawn from trends which may have a material impact. It would also give a description of any expected changes to the bank's business strategy.

3 Capital adequacy

- 3.1 This section would include a detailed review of the capital adequacy of the bank. It might start with a description of its risk appetite, which would set the context for the ICAAP. Where economic capital models are used, details of the assumptions behind those models should be included. Where scenario analyses are applied, some description of how the severity of scenario has been chosen should be included.
- 3.2 The ICAAP should include:

- 3.2.1 the date of the ICAAP calculations, together with consideration of any events between this date and the date of submission which would materially impact them, together with their effects;
- 3.2.2 details of, and rationale for, the time period over which assessments have been made;
- 3.2.3 identification of the key risks faced;
- 3.2.4 for each risk, an explanation of how the risk has been assessed and any quantitative results of that assessment;
- 3.2.5 an explanation of how the risks have been mitigated;
- 3.2.6 a clear articulation of the bank's risk appetite by risk type;
- 3.2.7 details of any restrictions on the ability to transfer capital into or out of the bank; and
- 3.2.8 an analysis of significant movements in available capital and capital required since the latest ICAAP and a comparison of the capital required under Pillar 1 calculations, as compared with the overall capital requirement identified by the ICAAP.

4 Key sensitivities and risk scenarios

- 4.1 This section would detail the sensitivity tests applied to key assumptions and factors that have a significant impact on the broader financial condition of the company. Material changes (past, present and future) in the financial risks to which the business is exposed would be explored and quantified as far as possible in this section.
- 4.2 Banks that have had Advanced Approaches approved should note that the above is in addition to any stress testing that might be undertaken for testing or supplementing risk modelling assumptions.

5 Reverse stress testing and recovery planning

- 5.1 A range of reverse stress test scenarios should then be described; for each the efficacy of the contingency plans should be examined. These should typically be two to four scenarios and include both systemic and idiosyncratic (bank only) stresses.
- 5.2 This section would also detail the contingency plans established to restore capital adequacy and maintain liquidity or otherwise mitigate the impact of severe stresses on the bank. These should:
 - 5.2.1 describe in sufficient detail the range of potential actions identified by the bank, which should include an assessment of the likely positive and adverse consequences;
 - 5.2.2 identify recovery triggers that would prompt consideration of management action; and
 - 5.2.3 establish for each potential management action the factors relevant to carrying it out, including (1) identification of responsibilities for considering and implementing each action, (2) identifying and addressing any barriers to actions, including the need for external stakeholder approval and the likely timescale for such action to commence or have effect, (3) communication, including with the JFSC and other

regulatory authorities, and (4) assessment of the credibility of each potential action.

- 5.3 The efficacy of the plans should be explored for each reverse stress test, including the identification of residual risks.

6 Aggregation

- 6.1 This section would describe how the results of the bank's various separate risk assessments are brought together and an overall view taken on capital adequacy. This requires a methodology to be used to quantify the amount of capital required to support individual risks in order to arrive at a total figure for capital required.

7 The challenge process and sign-off of the ICAAP

- 7.1 This section would describe the extent of challenge and testing of the ICAAP that has taken place. It would include the testing and control processes applied to the ICAAP calculations, the board review and sign-off procedures.
- 7.2 Details of the reliance placed on group ICAAPs or any external suppliers/consultants would also be detailed here e.g. for generating economic scenarios.

8 Use of the ICAAP within the bank

- 8.1 This would demonstrate the extent to which capital management is embedded within the bank, including the extent and use of capital modelling or scenario analysis and stress testing within the bank's capital management policy, e.g. in setting pricing. This would also include a statement of how the submitted ICAAP would be reflected in the bank's capital management policy.

Appendix B: Suggested Stress Tests

1 Summary

- 1.1 The JFSC facilitated the collection of stress test results from the Jersey banking sector in 2008, based on a standard suite of single factor stress tests defined by the IMF for use by it in its recent assessment of Jersey. The JFSC has also considered the different stress testing approaches reflected in the ICAAPs submitted by banks. Based on both aspects, the following stress tests are suggested, which banks should consider where there are material risks.
- 1.2 See also below outline guidance on the construction of stress scenarios in relation to a Eurozone or other fixed exchange rate regime crisis.

2 Single factor stress tests

2.1 Credit risk

- 2.1.1 The bank should consider the impact of the:
- 2.1.1.1 default of the three largest exposures that are covered by cash collateral or a parental guarantee;
 - 2.1.1.2 default of the three largest exposures where no such collateral exists;
 - 2.1.1.3 default of 10% of all mortgages by value;
 - 2.1.1.4 default of 10% of all loans by value;
 - 2.1.1.5 default of the parent, leading to a 20% loss on any direct loans and an increase in the related risk weighting of parent exposures to 150%, including the impact on indirect exposures, such as loans guaranteed by the parent;
 - 2.1.1.6 impact of a downgrade in respect of:
 - › parent or parent's jurisdiction;
 - › all ratings for all exposures where the risk weighting is determined by a credit rating that led to the following impact on risk weightings:
 - › 0% weighted assets becoming 20% weighted;
 - › 20% weighted assets becoming 50% weighted;
 - › 50% weighted assets becoming 100% weighted; and
 - › 100% weighted assets becoming 150% weighted.

2.2 Operational risk

- 2.2.1 The bank should consider the impact of:
- 2.2.1.1 worst case loss as a result of fraud;
 - 2.2.1.2 worst case loss as a result of mis-selling; and
 - 2.2.1.3 worst case loss as a result of pending litigation.

2.3 Market risk

2.3.1 The bank should consider the impact of:

2.3.1.1 a widening of spreads on all bonds held by 2%;

2.3.1.2 an increase in all foreign exchange rates of 10% across all currencies where this would cause a loss and a decrease of 10% where this would cause a loss;

2.3.1.3 an increase in all interest rates of 2% across all currencies where this would cause a loss and a decrease of 2% where this would cause a loss; and

2.3.1.4 the reduction in value of all listed equities held by 35%.

2.3.2 Where interest rates are low, such that a 2% cut would imply zero or negative rates, banks should consider the consequences of both of the following outcomes:

2.3.2.1 interest rates becoming negative, as indicated by a 2% fall; and

2.3.2.2 the impact of a long period of low rates. In this scenario, interest rates should be assumed to reduce to zero and remain at zero for all time periods where the bank's baseline prediction is for the interest rate to be 2% or less and thereafter remain 2% lower than the baseline.

3 Eurozone or other fixed exchange rate regime crisis

3.1 Introduction

3.1.1 Good risk management includes planning for unlikely severe scenarios. The guidelines outlined here were developed originally to be applied to scenarios addressing the disorderly exit of a country, or countries, from the Eurozone. Not all elements will be appropriate for all banks or indeed at all times, but many of the concepts are likely to remain relevant, for example in respect of an exit of a country from a fixed exchange rate regime or the breakdown of such a regime. Banks should consider both whether they are materially exposed to such events and the elements that apply in their specific circumstances.

3.2 Timing

3.2.1 Banks should consider an immediate announcement of an exit, whereby the exit is effected within one or two weeks, rather than assuming that an exit will only occur following an extended implementation period.

3.3 Events

3.3.1 Banks should consider the impact of, and explain contingency plans for, a range of scenarios including a full break-up and single country exits.

3.3.2 Alternative events (to an exit), such as the reset of fixed exchange rates, may be more relevant to fixed exchange rate systems, where (unlike the Eurozone) a single currency has not been established.

3.4 Capital controls

3.4.1 Banks should take into consideration counterparties in the affected countries potentially being prohibited from making payments to some extent, due to the imposition of capital controls and deposit controls.

3.5 Redenomination

- 3.5.1 Banks should consider the potential impact if relevant countries passed legislation:
 - 3.5.1.1 to redenominate all sovereign debt they have issued; or
 - 3.5.1.2 that requires all contracts that are subject to local law to be amended to convert amounts payable into the new local currency (at fixed exchange rates).
- 3.5.2 Banks should describe their contingency plans for carrying out redenomination into new local currencies, which should cover:
 - 3.5.2.1 how this would be effected on systems;
 - 3.5.2.2 how processes would need to be changed to handle the additional currencies, including the impact on transaction processes; and
 - 3.5.2.3 how customers and counterparties would be informed and any consents sought to changes in contracts.
- 3.5.3 Contingency plans should describe how resultant currency positions would be managed, including the circumstance of relevant foreign exchange markets freezing or being subject to extreme movements.
- 3.5.4 Banks should consider the impact of potential litigation, for example in circumstances where it is unclear how relevant contracts should be amended or whether payments should be stopped.
- 3.5.5 Banks should assess their current systems and identify any issues that need to be addressed immediately to enable necessary plans to be implemented, including ensuring that systems are capable of handling requisite new currencies.

3.6 Insolvency and illiquidity

- 3.6.1 Banks should consider the likely reaction of different sets of depositors. It should be anticipated that, both before and after legislation is passed, some depositors will seek to:
 - 3.6.1.1 move them to take advantage of the creation of strong new local currencies and /or avoid conversion to weak new local currencies; or
 - 3.6.1.2 convert them to other currencies to avoid forced conversions.
- 3.6.2 Banks also need to consider the likely immediate effect on different sets of counterparties, including their ability to make timely payments. Specifically, in the case of weaker countries exiting, banks should consider whether this would be likely to be accompanied by a default of both the sovereign and banks that have significant overseas liabilities.

3.7 Political and Economic Consequences

- 3.7.1 Banks should consider the likely longer term impact of the economic consequences of such scenarios, which requires inclusion of political consequences.

3.8 Timing of actions: immediate action versus contingency planning

- 3.8.1 Contingency plans should establish whether actions would become necessary if the threat became imminent or only undertaken post the event occurring.
- 3.8.2 In the former case, the contingency plan should identify the trigger for such actions.

Appendix C: Suggested Reverse Stress Tests

1 General guidance

- 1.1 Banks should use an appropriate number of market-wide (systemic) stress scenarios and group/bank-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.
- 1.2 These scenarios should address capital shortfalls and liquidity pressures and be severe enough to be useful in establishing and calibrating recovery triggers, estimating impacts of adverse situations, and contemplating responses to remediate both slow-moving and fast-moving adverse situations.
- 1.3 Banks should identify, assess and regularly update the scenarios most likely to cause their business model to become non-viable or to fail. Banks should include a range of credible options to be flexible enough to be effective in a variety of idiosyncratic, market-wide and combined stress circumstances.
- 1.4 Market-wide (systemic) stress scenarios should specify economic factors relevant to the bank, and hence enable estimation of likely impacts on, for example, the income statement, balance sheet, capital requirements, capital components, economic capital and material lines of business.

2 Critical components of reverse stress tests

- 2.1 Reverse stress-testing should include a range of severities for each scenario so that it is possible to demonstrate both where recovery actions would be necessary to ensure survival and identify very extreme conditions under which, even taking into account recovery plans, resolution would become necessary.
- 2.2 The number of scenarios will vary depending on the number of potential risks that could bring down the bank. As a minimum, banks are expected to identify at least one systemic or market-wide scenario and at least one idiosyncratic or group/bank-specific scenario. Scenarios would be expected to result from a number of factors, such as:
 - 2.2.1 significant capital and liquidity shortfalls at group level;
 - 2.2.2 severe group losses through a rogue trader;
 - 2.2.3 group rating downgrades;
 - 2.2.4 a currency crisis;
 - 2.2.5 a recession;
 - 2.2.6 loss of goodwill;
 - 2.2.7 exodus of talent;
 - 2.2.8 a run on banks in a particular country or perhaps affecting only a small number of banks that are perceived to be at risk;
 - 2.2.9 collapse of global financial markets;
 - 2.2.10 concerns regarding a sovereign and the knock on impact on banks holding its debt (whether accurate or not);

- 2.2.11 significant changes in commodity prices;
- 2.2.12 other banks failing;
- 2.2.13 significant losses as a result of fraud; and
- 2.2.14 reputational crises.

Appendix D: Recovery Triggers

1 General guidance

- 1.1 Recovery triggers should be calibrated so that they provide sufficient notice to allow the bank to take corrective action and for the supervisory authority to begin appropriate planning for taking early intervention measures, if this should become necessary.
- 1.2 Banks should explain how the calibrations were determined and provide relevant analysis that demonstrates that recovery triggers would be breached early enough to be effective.
- 1.3 Recovery triggers should not be linked to significantly lagging metrics, no matter how they are calibrated.
- 1.4 Banks should not rely solely on quantitative triggers, but should also incorporate qualitative triggers in their consideration of whether a recovery response is necessary.
- 1.5 The number and type of recovery triggers should be appropriate for the bank'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.
- 1.6 Banks should consider group recovery triggers both in designing local recovery triggers and from a consequential operational perspective.

2 Typical recovery triggers

- 2.1 Quantitative triggers should typically focus on the extent or speed of change in different elements affecting the group or the local bank, such as:
 - 2.1.1 ratings downgrades;
 - 2.1.2 revenue reports or P&L (or components of these);
 - 2.1.3 credit risk limits;
 - 2.1.4 equity ratios;
 - 2.1.5 liquidity indicators such as (1): rate of renewal of wholesale financing; (2) withdrawal of deposits and other funding; (3) increased collateral requirements; or (4) metrics derived from standardised group stress tests;
 - 2.1.6 market-based leverage ratios (market capitalisation of group as % of balance sheet or total debt);
 - 2.1.7 interbank rates; and
 - 2.1.8 senior debt and subordinated debt spreads.
- 2.2 Qualitative triggers could include elements, at both group and subsidiary level, such as:
 - 2.2.1 requests from counterparties for early redemption of liabilities;
 - 2.2.2 difficulties in issuing debt at current market rates;
 - 2.2.3 an unexpected loss of senior management;

- 2.2.4 adverse court rulings;
 - 2.2.5 negative market press; and
 - 2.2.6 significant actual or potential reputational damage, including, as an example only, as a result of operational issues such as its website repeatedly crashing, loss of personal data, failure to process transactions or the uncovering of a rogue trader.
- 2.3 In addition to recovery triggers, banks should monitor early warning indicators (**EWIs**) that are calibrated to identify negative trends and are monitored on a business-as-usual basis. These indicators are conceptually similar to recovery 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.

Appendix E: Recovery Plan: Management Actions

1 Overview

- 1.1 A recovery trigger being breached should cause a predetermined escalation and information process up to senior management/Board within the bank and within group.
- 1.2 The recovery plan should articulate the escalation process to a firm's senior management or board of directors when recovery triggers are breached, and the decision-making process once those parties have been informed.
- 1.3 Although a triggering event usually results in the bank taking a recovery action, this might not be required in every case. Banks 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.
- 1.4 Banks should document the range of actions that could be taken and the circumstances in which they might be effective in restoring capital adequacy or liquidity, or otherwise mitigate potential consequences of the stressed situation.
- 1.5 This should include responsibility for both the decision and implementing it.
- 1.6 Responsibility for decision making is with the bank's Board, where not delegated.
- 1.7 Any need for Group or shareholder approval for actions should be addressed, particularly where support is needed.
- 1.8 Where the need for Group or shareholder approval presents a potential barrier to local action, this should be considered and addressed, for example, by seeking approvals identified as being necessary ahead of any crisis.
- 1.9 For each action, an assessment of the impact should consider the timescale for it to be implemented and take effect. Comprehensive detail will be required, including with respect to internal and external communication.
- 1.10 The latter should include consideration of how the action would be communicated to customers, the press, the JFSC and other relevant authorities (see Section 2).
- 1.11 The overall credibility of individual actions should be considered, taking into account all of the above considerations, and the recovery plan's overall credibility should also be assessed by the bank.
- 1.12 For the avoidance of doubt, no part of the action plan is expected to constitute a plan for resolving the bank in the event of failure. Instead, the bank should document actions that it can take itself or with the co-operation of its group to recover from stresses.

2 Communication with supervisory and resolution authorities

- 2.1 Banks should advise the JFSC of any significant changes to recovery plans.
- 2.2 Banks should promptly communicate with the JFSC and other supervisory authorities (and resolution authorities where appropriate) that oversee branches in cases where a recovery trigger is triggered or the bank determines that it is experiencing high levels of stress.
- 2.3 Communication should include:
 - 2.3.1 the fact of a recovery trigger being breached;
 - 2.3.2 the circumstances leading to the breach;
 - 2.3.3 the expected impact on the bank, including any concern regarding whether the bank is insolvent or illiquid or could become so if planned actions are not effective;
 - 2.3.4 any actions already taken; and, whether these are considered to be a sufficient response;
 - 2.3.5 actions being considered, whether prompted by the recovery plan or not, which should be sufficiently detailed as to identify:
 - 2.3.5.1 who is making decisions;
 - 2.3.5.2 barriers that need to be addressed;
 - 2.3.5.3 the expected benefits of the actions; and
 - 2.3.5.4 any expected adverse consequences or risks relating to the actions.
- 2.4 Where some of these matters have not been determined, communication will need to be limited to those that are known, with prompt follow up as and when other matters are determined.