PRUDENTIAL PRACTICE GUIDE

Draft CPG 190 Financial Contingency Planning

Integrated version

September 2022

Contents

About this guide

Prudential practice guides (PPGs) provide guidance on APRA's view of sound practice in particular areas. PPGs frequently discuss legal requirements from legislation, regulations or APRA's prudential standards, but do not themselves create enforceable requirements.

This PPG sets out guidance for all APRA-regulated entities to assist in the implementation of *Prudential Standard CPS 190 Financial Contingency Planning* (CPS 190). Under CPS 190, all APRA-regulated entities are required to undertake financial contingency planning so that they are ready to respond to severe financial stress that may threaten their viability.

This PPG, *Prudential Practice Guide CPG 190 Financial Contingency Planning* (CPG 190), provides guidance to support the implementation of CPS 190. It sets out the key areas of focus that APRA supervisors will have when assessing an entity's financial contingency planning.

CPS 190 sets requirements for all APRA-regulated entities, proportionate to their size and complexity. Not all of the practices outlined in this PPG will be relevant for every entity; for example, certain guidance relates to requirements that apply only to significant financial institutions (SFIs). Subject to meeting their requirements under CPS 190, APRA-regulated entities have the flexibility to manage their financial contingency planning practices in a manner that is best suited to achieving their objectives.

This integrated version of CPG 190 maps APRA's guidance to the relevant paragraphs in CPS 190. Paragraphs from CPS 190, which are enforceable requirements, have been set out in blue boxes like this; the accompanying guidance follows below, outside the blue boxes.

APRA has mapped guidance to Part A (Requirements for SFIs) of CPS 190. Non-SFIs should also refer to this guidance for common areas of overlap. Where guidance relates to requirements that apply to SFIs only, this has been marked as such.

Glossary

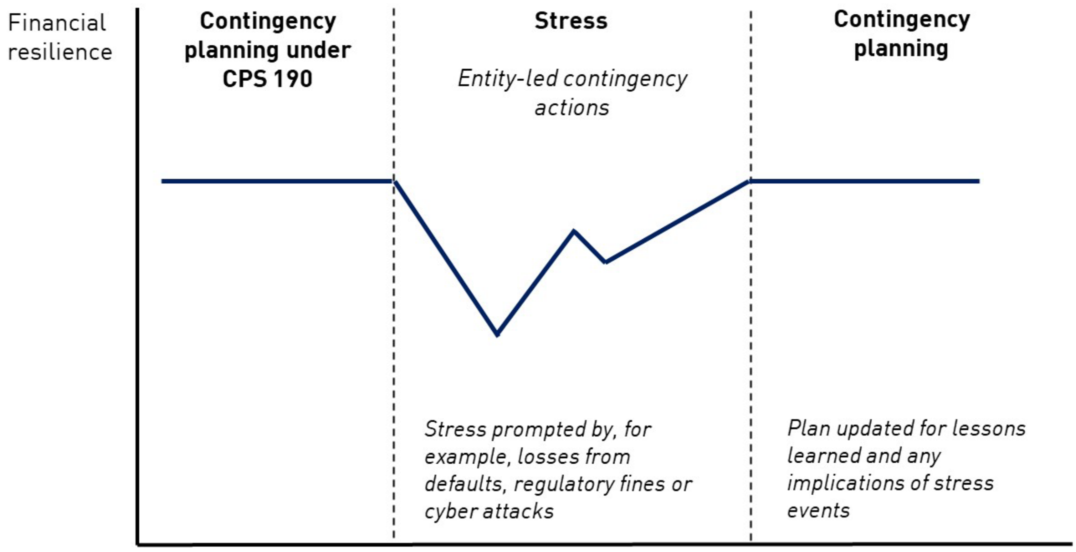
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
CPS 190	*Prudential Standard CPS 190 Financial Contingency Planning*
CPS 900	*Prudential Standard CPS 900 Resolution Planning*
ICAAP	Internal Capital Adequacy Assessment Process
Non-SFI	Non-significant financial institution
PPG	Prudential practice guide
RSE	Registrable superannuation entity
RSE licensee	Registrable superannuation entity licensee as defined in s10(1) of the *Superannuation Industry (Supervision) Act 1993*
SFI	Significant financial institution

Contingency planning

> *13. An APRA-regulated entity must develop and maintain a financial contingency plan (contingency plan) that sets out how it would respond to a stress that threatens its viability. The contingency plan must demonstrate how the APRA-regulated entity could:*
>
> *a) take actions to recover its financial resilience; and*
>
> *b) enable its orderly and solvent exit from regulated activity, if actions to recover financial resilience are not effective.*

Historical experience has shown that entities who are not adequately prepared for severe stress will often experience difficulties restoring their financial strength or exiting the industry in an orderly manner. A financial contingency plan sets out the steps an APRA-regulated entity could credibly take to avoid its failure and protect depositors, insurance policyholders and superannuation fund members. When used effectively, these plans should enable regulated entities to restore their businesses to a stable and viable position in a timely manner during stress (see Figure 1).

Figure 1. Indicative contingency planning lifecycle



The main components of a financial contingency plan, as required under CPS 190, are summarised below (see Figure 2).

Figure 2. Key components of the contingency plan

14. *The contingency plan must be appropriate to the size, business mix and complexity of the APRA-regulated entity and, for an RSE licensee, the RSE licensee's business operations. Where an APRA-regulated entity is the Head of a group, it must include all material regulated activities of the group in its contingency plan.*

15. *The contingency plan must be integrated into:*

    a) *the APRA-regulated entity's risk management framework; and*

    b) *for an ADI or an insurer, capital management and liquidity management frameworks, as relevant; or*

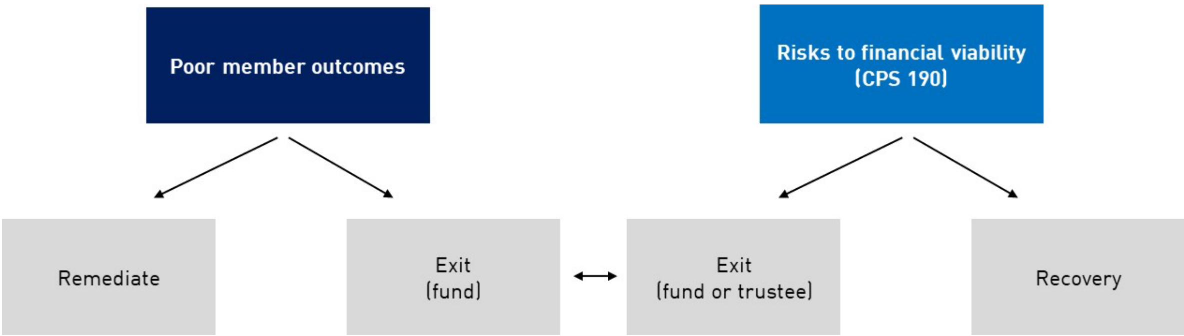
    c) *for an RSE licensee, the business plan and business performance review.*

16. *An APRA-regulated entity must not assume extraordinary public sector support or the use of APRA's powers in its contingency planning.*

The financial contingency plan is an important part of an entity's risk management framework and must be integrated appropriately. For ADIs and insurers, there are important linkages to the Internal Capital Adequacy Assessment Process (ICAAP), contingency funding plans and risk appetite. For example, triggers used in financial contingency planning would support an entity in meeting its overall risk appetite. They would also support an entity in transitioning capital planning from business-as-usual (ICAAP) to a contingency response.

For RSE licensees, CPS 190 is focused on managing risks to the trustee's financial viability (for example, insolvency). This is intended to supplement, but not replace, the actions that an RSE licensee would take to address poor member outcomes. Figure 3 below provides a stylised comparison of the actions that an RSE licensee could take in these scenarios. Under all circumstances, an RSE licensee must be able to demonstrate how its contingency actions would be consistent with the RSE licensee's legal obligations, including the duty to act in the best financial interests of beneficiaries.

Figure 3. Superannuation: poor member outcomes and financial viability



For foreign banks and insurers that have branch or locally-incorporated operations in Australia, it is important that the local financial contingency plan is appropriately integrated with head office or group arrangements. This is particularly important where there may be a material dependency on contingency actions at this level. It is better practice for local operations to consider other credible options available to them, beyond these sources. The financial contingency plan would be appropriate for local risks, with scenarios and triggers relevant to stresses that may be experienced in Australia.

Where APRA has determined a resolution plan for an entity under *Prudential Standard CPS 900 Resolution Planning* (CPS 900), a prudent entity would update its financial contingency plan to align with any implications of the resolution plan. For example, executing certain contingency actions could undermine the effectiveness of resolution pre-positioning measures, such as divestments; conversely, certain pre-positioning measures, such as changes in structure, could impact an entity's contingency planning.

Role of the Board

17. *The Board of an APRA-regulated entity is ultimately responsible for the oversight of contingency planning. The Board must ensure that there are clear roles and responsibilities at a senior executive level for the preparation, maintenance and execution of the contingency plan.*

18. *The Board must:*

    a) *approve the contingency plan;*

    b) *oversee reviews of the contingency plan and ensure any findings are addressed by management; and*

    c) *oversee the execution of any contingency actions.*

An effective financial contingency plan would support the Board of an APRA-regulated entity in responding to stress that could threaten its financial viability. It is important that Boards have confidence in the assumptions relied upon and the credibility of actions contained within financial contingency plans.

As a key user of the plan, it is important that the Board can quickly navigate and easily understand it. A prudent Board would use simulation exercises to test the effectiveness of the plan in meeting their needs.

Changes in market conditions, business models or growth plans can impact the assumptions used in financial contingency planning, and it is important that the plan continually evolves over time. APRA expects that the Board would hold management to account for keeping the plan current and effective.

Ineffective execution of financial contingency actions can have serious consequences on an entity's prudential standing and reputation. Failed transfers, for example, can undermine stakeholder confidence, amplify the impacts of stress and increase the likelihood of failure.

Developing the plan

19. An APRA-regulated entity's contingency plan must include:

a) a concise summary that provides a standalone guide to use the contingency plan; (SFIs only)

b) a trigger framework for the early identification and monitoring of stress. The trigger framework must be relevant to the operating environment and risk profile of the APRA-regulated entity, and include a range of early warning indicators to support the effective activation and implementation of the contingency plan;

The purpose of the trigger framework is to support the entity in identifying, at an early stage, stress that could threaten its financial viability. APRA would not expect the trigger framework to operate in a mechanical manner: a prudent entity would not wait for triggers to be breached, should there be a need for timely action; conversely, breaching a trigger would not result in an automatic predetermined course of action. A well-designed trigger framework would be integrated with other monitoring or early warning indicators in the risk management framework and support an entity in meeting its risk appetite.

Triggers that are set at an early stage would allow the entity to begin preparing for the potential implementation of contingency actions as stress unfolds. Better practice would be to use cascading triggers, to support a graduated dialling up of an entity's crisis response. For example, initial trigger points could serve as a prompt for enacting governance arrangements under the contingency plan, while subsequent trigger points could prompt a closer examination of certain contingency actions.

The earlier the entity begins preparing for the execution of potential contingency actions, the greater the likelihood that these will be successful. The types of triggers to be included in the framework are therefore an important consideration. A prudent trigger framework would include a variety of indicators of stress, based on both actual and forecast outcomes. These indicators could include measures of economic stress, balance sheet or profitability vulnerabilities, or sustainability concerns.

A prudent trigger framework would also be appropriately calibrated to the types of actions in the contingency plan. For example, an entity that is reliant on contingency actions with long implementation timeframes would typically set triggers at an early stage to ensure that the estimated benefits from contingency actions can be fully realised. This includes actions that depend on external investors completing due diligence. Due diligence for asset sales or transfers could take several months, particularly if limited pre-positioning has taken place.

c) governance arrangements for the monitoring of triggers and timely activation of the contingency plan or specific actions within it;

It is important that there are clear responsibilities for the regular monitoring of triggers and decision making regarding the use of the plan. Prudent entities would integrate the monitoring of financial contingency plan triggers into existing risk management processes and decision-making forums, where appropriate.

A prudent financial contingency plan would clearly set out accountabilities for activating the plan and, where appropriate, the implementation of specific contingency actions within it. Successful execution of contingency actions would require strong coordination from a range of stakeholders including, for example, communications, finance and risk teams.

> *d) credible recovery actions that could be taken to stabilise and restore financial resilience;*
>
> *e) credible exit actions that could be taken to effect an orderly and solvent exit from regulated activity;*

A prudent contingency plan would identify a menu of credible contingency actions to provide flexibility in responding to stress. Listing the actions that were considered, but not included in the financial contingency plan, can also be important in demonstrating why they would not be credible options in stress. Table 1 below sets out examples of common contingency actions that have been used domestically and internationally in responding to stress.

Table 1. Illustrative examples of contingency actions

Recovery actions	Exit actions
Earnings retention Cost savings Capital raising or injection Asset sales Risk reduction Changes to business and investment strategies Liability management Run-off of lines of business	Solvent wind-down Return of deposits Voluntary transfer to another regulated entity Successor fund transfer Change of trustee

The type of contingency actions that would be considered credible will differ according to the industry an entity operates in, its ownership structure, its business model and its risk profile. For example, capital raisings may not be a credible option for certain entities, based on their ownership structure. Larger and more complex entities would be more likely to have access to a wide range of credible recovery actions.

Relying on a limited number of actions would provide less flexibility in responding to stress. In these circumstances, a prudent entity would place a very strong focus on preparatory measures to reduce the risk that the execution of that action may not go according to plan. This could include developing 'playbooks', which set out detailed instructions for executing contingency actions under various scenarios. It could also include prior engagement with potential transfer partners, to understand the information that would be necessary for due diligence, the conditions under which a transfer may not be feasible and the time needed for implementation.

Where entities have material overseas subsidiaries, it would be prudent to identify contingency actions that could be undertaken by the local subsidiary in those jurisdictions, rather than relying solely on parental support.

> f) *scenario analysis that assesses the effectiveness of the trigger framework, shows how contingency actions would be implemented, and measures the impact and effectiveness of those actions. This analysis must include at least two scenarios that are severe enough to threaten the APRA-regulated entity's viability, including a systemic and an idiosyncratic stress;* ***(SFIs only)***

The purpose of scenario analysis is to test the effectiveness of an entity's planned contingency responses and its overall recovery capacity. It is an important complement to stress testing, which provides a forecast of the impact of stress on an entity's balance sheet and cashflows.

It is good practice to tailor scenarios to an entity's risk profile. For example, scenarios could consider how an entity's planned actions could be impacted by the actions of its competitors, by different time dimensions ('fast' or 'slow' burn scenarios) or by market sentiment.

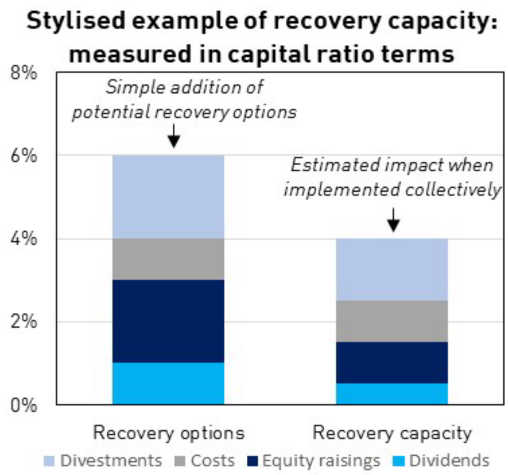
When undertaken effectively, scenario analysis can provide important insights for assessing the credibility of actions. For example, scenario analysis could indicate that implementation timelines may be longer than anticipated or there are additional dependencies which have not been considered. Prudent entities would use lessons learned from scenario analysis to strengthen their contingency plans.

> g) *an assessment of recovery capacity, which is the aggregate impact of plausible recovery actions under each scenario. Recovery capacity must be measured in quantitative terms by calculating the amount of capital and liquidity that can be rebuilt during or following stress; and* ***(SFIs only)***

Recovery capacity would not typically be a straight-line summation of the estimated impact of each recovery action. There are important dependencies between contingency actions that could cause some to be mutually exclusive or their effectiveness diminished when executed in parallel. For example, executing an equity raising following a large divestment could have a smaller impact than otherwise assumed, since investors may have much lower expectations for future earnings.

In calculating recovery capacity, it is good practice to explain the assumptions made, including the timing and sequence in which actions are executed. For example, some actions might only be effective in the early stages of stress and before losses are incurred, such as earnings retention. Other contingency actions can have material impacts on an entity's business model or investor sentiment, which may undermine the effectiveness of subsequent actions.

A stylised example of recovery capacity for a bank, shown in the chart opposite, would be the cumulative ability to rebuild 4 percentage points of common equity tier 1 (CET1) capital over a stressed scenario. This example considers the interdependencies between equity raisings, divestments, cost cutting and dividend reductions.



> *h) a communication strategy to support the execution of contingency actions.*

Maintaining stakeholder confidence is critical to the effective execution of many contingency actions, including equity raisings, transfers or asset sales. Failure to disseminate timely and appropriate information can give rise to significant execution risks.

A prudent entity would identify the key stakeholders for particular contingency actions, and tailor communications strategies appropriately. For example, an effective communication strategy for a return of deposits would likely look very different to an equity raising or a transfer. It is good practice to have pre-prepared communication documentation for each contingency action.

A prudent entity would also set out the approach to engaging with regulators and, where appropriate, meeting disclosure requirements. CPS 190 requires an entity to notify APRA if it has activated its contingency plan. While this would ultimately be a matter of judgement, activation could result from an entity enacting any part of the plan, including forming contingency governance arrangements.

Maintaining regular and open dialogue with regulators as stress unfolds is an important consideration for entities. Prudent entities would seek to anticipate the information needs of various regulators, across key jurisdictions.

> *20. For each recovery and exit action in the contingency plan, an APRA-regulated entity must include:*
>
> *a) a timeline for the implementation of the action;* ***(SFIs only)***

A prudent entity would assess both the time needed to execute an action and the time needed to realise its full benefits. Execution times can be influenced by a range of factors, including governance processes, regulatory approvals and the need for external due diligence.

> *b) analysis of any barriers to implementation, execution risks and key dependencies;* ***(SFIs only)***

A comprehensive assessment of barriers to implementation is a key indicator of credibility. Impediments could arise from a range of sources, including interconnectedness, legal, regulatory or operational barriers.

Some actions could be subject to high execution risks, given the number of stakeholders, complexity of the action or reliance on the sentiment of external parties. A prudent entity would also assess the secondary impacts from executing actions, such as impacts for credit ratings or the cost of funding, where appropriate.

> c) *a summary of the preparatory measures needed to support the timely and effective execution of the action; and* ***(SFIs only)***

Preparatory measures can significantly improve the speed and impact of executing contingency actions. There are a range of measures entities could take to strengthen the credibility of their actions including, for example, pre-prepared documentation or approvals, the development of playbooks or improvements to data systems. For asset sales or transfers, prior engagement with potential acquirers can materially improve credibility.

> d) *where relevant, an estimate of the impact of the action on the capital and liquidity position of the APRA-regulated entity, based on credible assumptions.* ***(SFIs only)***

Good practice would be for the estimated impact of each contingency action to be quantified both in nominal terms and prudential ratio terms, where appropriate. In the case of RSE licensees, the impact of a contingency action on the financial resources available to fund their business operations would be a useful part of the assessment.

A prudent entity would ensure that the estimated financial impacts are based on robust analysis and that any key assumptions are subject to challenge and scrutiny, informed by both historical and international benchmarks where appropriate.

APRA expects that valuation practices would be conservative, based on stressed assumptions. Haircuts, for example, would be applied to asset values to reflect stressed market conditions and transaction costs.

> 21. *The Board must form a view on the sufficiency of recovery capacity to restore financial resilience and where this is insufficient, consider other actions the APRA-regulated entity may add to the contingency plan or other actions to improve recovery capacity.* ***(SFIs only)***

Recovery capacity is an important indicator of the aggregate effectiveness of recovery actions; it demonstrates the total amount of losses that could be offset from implementing plausible recovery actions in stress. Where the Board of an SFI forms a view that recovery capacity is not sufficient to restore financial resilience in stress, it must consider other actions to improve recovery capacity. This could include adding additional actions to the contingency plan or taking additional preparatory steps to increase the effectiveness of existing actions. Entities could also strengthen their existing financial resilience, such as holding higher regulatory capital, if there is limited scope to improve recovery capacity.

22. APRA may require:

a) the inclusion or exclusion of a particular recovery or exit action within the contingency plan;

b) the inclusion of an APRA-determined scenario in the contingency plan; or

c) the use of particular assumptions when assessing recovery capacity.

(SFIs only)

23. For an APRA-regulated entity that is not an RSE licensee, APRA may adjust prudential requirements for capital and liquidity where it assesses there to be material weaknesses in the contingency plan.

Maintaining the plan

Capabilities, monitoring and execution

24. *An APRA-regulated entity must maintain the capabilities required to execute the contingency plan.*

25. *An APRA-regulated entity must regularly monitor the indicators of stress that would be used to trigger activation of the contingency plan or the specific actions within it.*

26. *An APRA-regulated entity must take reasonable preparatory steps to support the timely and effective implementation of the contingency plan, in advance of recovery or exit actions being required. This must take into consideration potential legal, financial, operational and structural requirements for executing recovery or exit actions.*

27. *An APRA-regulated entity must maintain access to sufficient financial resources to support the implementation of recovery and exit actions contained in the contingency plan.*

Maintaining capabilities could include, for example, strategies for accessing financial resources that may be needed to support the implementation of planned actions. Some actions, such as transfers, may involve fees for external parties to support effective implementation. A prudent entity would also assess the operational or liquidity requirements for implementing wind-down or run-off strategies, such as a return of deposits.

Certain contingency actions can also have unintended impacts; for example, the sale of assets could boost capital, but weaken liquidity. It is important that contingency plans assess flow on impacts, so that net benefits can be estimated.

Testing and review

28. *An APRA-regulated entity must review and update its contingency plan on an annual basis* ***[every three years for non-SFIs]****, or as otherwise determined by APRA. The contingency plan must be updated to reflect any changes in legal or organisational structure, business mix, strategy or risk profile.*

29. *An APRA-regulated entity must undertake a comprehensive review at least every three years of the effectiveness of the contingency plan and its readiness and capabilities to execute it. The comprehensive review must be conducted by operationally independent, appropriately experienced and competent persons.* ***(SFIs only)***

30. *As part of the comprehensive review, an APRA-regulated entity must conduct operational testing to simulate the use of the contingency plan. This must involve a test of the governance arrangements, communication plan, operational elements of key actions, and internal reporting.* ***(SFIs only)***

APRA expects that contingency plans will remain current and effective. While CPS 190 sets minimum review requirements, better practice would be to update plans more regularly if an entity becomes aware of information that could materially impact its effectiveness.

Operational testing is a critical way of assessing the plan, through a 'live' simulation with key decision makers and stakeholders. This provides an opportunity to test the way the plan might work in practice using a scenario. It is important that simulations are as realistic as possible; for example, new information would only become apparent as the event unfolds.

The three-yearly review would be a deeper dive than the annual process and could include, for example, benchmarking against better practices domestically and internationally. External specialists could be used to facilitate simulations or develop additional capability.

Notification

31. *An APRA-regulated entity must provide a copy of the contingency plan to APRA on an annual basis, within three months of the contingency plan being approved by the Board. (SFIs only)*

32. *An APRA-regulated entity must notify APRA if it has activated its contingency plan.*