

# TRADING WIND-DOWN: EXPECTATIONS AND CONSIDERATIONS

## INTRODUCTION

In a move to improve the resilience of the UK financial sector, the Prudential Regulation Authority (PRA) issued **Supervisory Statement (SS) 1/22 in May 2022**. This statement delineates the expectations for certain firms involved in trading activities that could pose significant adverse effects on the stability of UK's financial sector.

The SS requires the firms falling within its scope to **be able to implement a full or partial winddown of their trading activities during recovery and post-resolution restructuring**. This requirement aims to ensure an orderly resolution process that minimizes the impact on the broader financial system in the event of financial distress. With the mandated deadline looming, firms are actively striving to meet the requirements set by the PRA. Firms are keen on adhering to these policy requirements now more than ever due to the current market conditions.

### TIMELINE

PRA expects firms falling within the Scope of the SS 1/22 to meet its policy requirements by **3rd March 2025**.

## FIRMS IN SCOPE

The Supervisory Statement applies to firms falling under the following three criteria:

- i. Firms identified by the PRA as Other Systemically Important Institutions (O-SIIs) based on their potential impact on the stability of the financial sector;
- ii. Firms that have the option to fully or partially wind down their trading activities as part of their recovery and post-resolution restructuring option; and,
- iii. Firms that have been notified by the Bank of England regarding their preferred resolution strategy being Bank-led bail-in or have been identified as a 'material subsidiary' of a third-country group for the purpose of establishing internal Minimum Requirements for their own funds and Eligible Liabilities (MREL) in the UK.

## OBJECTIVES OF THE STATEMENT

The key objectives of SS1/22 are to ensure that firms have a credible recovery plan, including a total wind-down (TWD) option, to stabilize their balance sheets amidst potential capital and liquidity impacts during times of financial distress. Additionally, the statement aims to ensure firms are prepared for resolution, considering the potential capital and liquidity impacts that may arise. The statement also emphasizes the need for appropriate governance and assurance surrounding TWD options and capabilities. The implementation of these expectations is crucial in maintaining the stability of the financial sector in events of financial distress.

## PRECEDING REGULATORY DOCUMENTS

The Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) have published guidance, thematic review papers, and supervisory statements for firms engaged in trading activities. The publication of the wind-down planning guide (WDPG) by the FCA in December 2016 was the first milestone. In April 2022, FCA published a thematic review paper, titled "Observations on wind-down planning: liquidity, triggers & intragroup

dependencies" (TR22/1). The paper highlighted the importance of ensuring the credibility and operability of firms' wind-down plans. The FCA emphasized in the paper that substantial work was still required to enhance wind-down planning, particularly concerning intra-group dependencies and the calibration of wind-down triggers.

In May 2022, PRA published the Supervisory Statement (SS) 1/22 and the Statement of Policy (SOP) paper on Trading activity wind-down. These publications elaborated PRA's current expectations regarding Trading wind-down. In the SOP on TWD, PRA has guided that the following policies and rules (shown in Figure 1 below) are relevant for wind-down planning of trading activities:

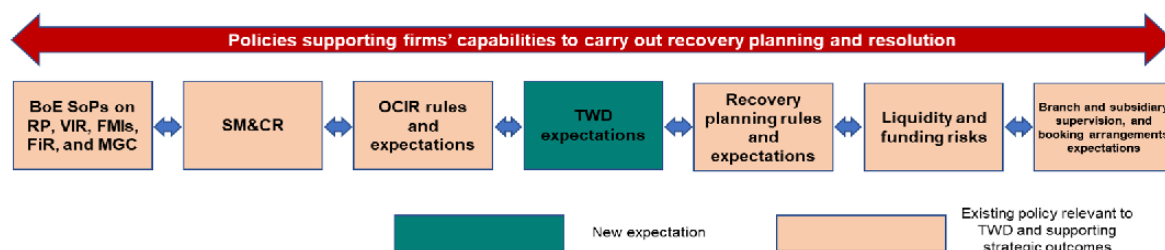


Figure 1, Source: PRA SoP 'Trading Activity Wind-Down' (2022)

## PRA EXPECTATIONS

The PRA expects firms to comprehend their own business models and be cognizant of the impact of a disorderly wind-down of trading activities on their financial position.

We have listed some of the foundational expectations and examples of potential TWD arrangements that the PRA requires TWD firms to account for whilst developing the TWD option.

### Foundational Expectations from Firms

The PRA SS 1/22 highlights the following foundational expectations from TWD firms:

1. As with any recovery options, a TWD option should define the **actions, arrangements, and measures** that the TWD firm would implement in a scenario of macroeconomic and financial stress. These actions should allow the firm to reduce risk and leverage and wind down trading activities in an orderly manner.
2. The TWD option should be explained in the firm's **recovery plan** and in the **playbook** where relevant to ensure efficient implementation during stress.
3. TWD firms must consider relevant information that will need to be provided to bolster the **viability and credibility** of the TWD option in recovery.

Source: SS1/22 Para 3.2 to 3.4

### Potential Actions and Arrangements

The PRA SS 1/22 identifies a non-exhaustive list of six actions a TWD option might include:

1. Division of trading activities into segments (**segmentation**) with individual exit strategies;
2. Close-out or terminating positions before maturity;
3. Allowing contracts to run to maturity without being replaced (**a contractual run-off**);
4. Auction or transfer of positions to a third party or deploying '**novation**' (replacing an old contract with a new economically equivalent one with a different party);
5. Actions taken to **reduce risk via hedging**; and,
6. Actions taken to **manage the liquidity of the balance sheet**.

Source: SS1/22 Box 1

## FURTHER PRA EXPECTATIONS

In line with the PRA's directives, firms are required to contemplate a range of scenarios of severe macroeconomic and financial stress relevant to their conditions. They must incorporate factors relating to firm-specific stress, market-wide stress, and factors relating to a full or partial wind-down of trading activities. By engaging in **Scenario Testing**, firms can enhance their preparedness for adverse conditions and mitigate potential risks.

The PRA emphasizes the importance of **Ensuring Flexibility of the Recovery Plan**. The firm should be able to flexibly amend its actions, arrangements, and measures to demonstrate the TWD option's credibility. The TWD firm should also be able to set out which alternative actions, arrangements, and measures it would adopt if it were to modify its approach.

The PRA expects TWD firms to have robust **TWD capabilities**. Firm's **TWD capabilities** should permit the execution of the TWD option in a range of real-life circumstances. Moreover, the PRA expects firms to **Execute their TWD Option** in line with its expectations outlined in Supervisory Statement 9/17.

More importantly, PRA expects the firms to be able to **execute TWD option in a timely manner**. TWD firms should have the capability to refresh data on their balance sheet, winddown costs, and capital and liquidity projections, within a short time frame. TWD firms should be able to refresh the material components of the TWD option, including changes to assumptions, approximations, modelling, methodology, decision-making capabilities, and factors that make up the TWD scenario within days.

## HOW WE ARE HELPING OUR CLIENTS

Avantage Reply has supported a range of clients on various elements of recovery and resolution planning and is deeply involved in understanding regulatory expectations. We have previously advised a multi-asset broker in **the development of a Wind-Down Plan** (WDP) following feedback from the FCA.

Below are key considerations and how we can help firms develop a TWD Plan in line with PRA guidance:

### GOVERNANCE

#### PRA Guidance:

*TWD firms must evidence that its board has appropriately overseen the development of the TWD capabilities and also document any alternative approaches (Para 4.58).*

#### Our Recommended Actions:

We help firms **identify key stakeholders** within the organisation who will be involved with the planning process, **including experts from different business units** and external experts where relevant. We support firms in **documenting the design, implementation, and testing processes** of the TWD plan and the decision-making processes attached to each in granular detail. Moreover, we aid firms in **designing clear quantitative indicators and thresholds** which would allow the board to make timely decisions in a circumstance the TWD Plan needs to be implemented.

### SCENARIO SELECTION

#### PRA Guidance:

*The scenarios must be sufficiently severe, relevant to the business model, and capable of taking the firm to a point of near failure (Para 3.6).*

#### Our Recommended Actions:

As a starting point, we collaborate with firms to identify their **key revenue drivers, client portfolio, potentially vulnerable business areas, and operating models** to account for in a scenario analysis. It is crucial for firms to **document the decision-making process** of how scenarios are selected and highlight the reasons why a scenario is included or not included. Among other factors, scenarios should include situations where revenue drivers are lost without realistic replacement prospects, critical infrastructure is disrupted without timely recovery, and financial losses are rapidly multiplying.

## IMPACT ASSESSMENT

### PRA Guidance:

*TWD firms should estimate the impact of a disorderly trading wind-down on their balance sheets as well as on UK financial stability (Para 2.2 and 6.4)*

### Our Recommended Actions:

We help the firms determine the impact of TWD **on the firm's clients, employees, contractual relationships with relevant creditors, and the wider UK market**. We aid firms in planning how quickly the firm can conclude **outstanding transactions, return client monies and custody assets**, and whether there will be any tax or other implications to the clients. We aid firms in estimating whether there could be **any impediments which could impact the wind-down costs and timing** of the TWD plan implementation

## OPERATIONAL ANALYSIS

### PRA Guidance:

*TWD firms should be able to identify and project operational dependencies and model the time profile of operational costs expected to be incurred in the TWD scenario (Para 4.36).*

### Our Recommended Actions:

We work closely with firms to **evaluate the industry and sector the firm operates in** and the impact on the wider UK market as a result of implementing a TWD plan. We support firms in reviewing the cost impact emerging from **contractual commitments with internal and external stakeholders**. Additionally, we assist firms in evaluating their organizational structure, target operating model, internal processes, and systems, especially ones that are **inter-connected or outsourced for impacts arising from the TWD scenario**.

## FINANCIAL RESOURCE PROJECTIONS

### PRA Guidance:

*TWD firms should be able to project the exit costs, operational costs, capital resource impacts and requirements emerging from the TWD plan (Para 4.13).*

### Our Recommended Actions:

We help firms **determine methods of monitoring cash inflows and outflows** during the TWD period as there is an increased likelihood of non-routine cash flows during this period. We aid firms in **identifying the scope of financial resources** needed to implement a TWD plan, while also considering whether the firm has adequate resources to ensure an orderly wind-down if the group entity also failed in the process. Furthermore, we help firms **identify the key indicators relied upon for the financial resource projection calculations** and ensure their continued production through adequate contingency plans, especially if their production or reporting is reliant upon outsourced services.

## FINANCIAL ANALYSIS

### PRA Guidance:

*TWD firms should have the methodologies and models to forecast the impact of the TWD scenario on capital requirements, capital resources, and liquidity (Para 4.25).*

### Our Recommended Actions:

We aid firms in identifying and providing relevant figures from the balance sheet, P&L, capital and liquidity positions as a **starting point for projecting the impact of the TWD scenario**. We assist firms to **forecast positions of the balance sheet, P&L, and capital and liquidity** during the TWD period. Moreover, **we help them forecast monthly projections of the balance sheet, P&L, as well as capital and liquidity positions for the scenario impact period** as these figures would show how the scenario would have affected the firm while the Board of Directors determined whether to invoke the TWD Plan.

## COMMUNICATION PLANS

### PRA Guidance:

*Whilst there are no expectations on communication plans in SS 1/22, the Statement refers firms to the SoP on Management, Governance, and Communication (Para 1.20).*

### Our Recommended Actions:

We collaboratively work with firms to help them **define the internal process for drafting and approving any communications** to relevant internal and external stakeholders. We help firms evaluate the requirement for the governing body to **engage with any legal advisors** to assess for potential liability or legal impact and **communication advisors for media training**. Moreover, we assist firms in **designing guidance and procedures for a proactive or reactive communication strategy** (or a combination) and prepare scripts for external engagement wherever relevant.

## WHO TO TALK TO?



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## AVANTAGE REPLY

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