FINANCIAL CONDUCT AUTHORITY

Observations on wind-down planning: liquidity, triggers & intragroup dependencies

Thematic Review
TR22/1

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Contents

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1 Summary

Introduction

1.1 We recently completed a piece of thematic work on wind-down planning across a number of different business models, in light of the on-going COVID-19 pandemic. We focused on liquidity needs during wind-down and examined firms' intra-group dependencies and wind-down triggers.

1.2 The exercise sought to ensure that the largest firms in several key sectors held sufficient liquid resources to fund a wind-down if required, given the turbulent economic environment. In fact, it showed widespread weakness in wind-down planning and the need for firms to improve their wind-down planning and processes as well as their wind-down planning documentation.

Our observations

1.3 Our work highlighted that, where they existed, most wind-down plans, processes and risk management frameworks (RMFs) remained at an early stage of maturity. Many have substantial gaps and do not reflect the minimum expectations highlighted in the Wind-Down Planning Guidance (WDPG) and 'Our framework: assessing adequate financial resources' (FG20/1).

1.4 Our key observations are:

- Significant further work is needed to ensure that the wind-down planning of firms is credible and operable. This particularly relates to liquidity and cashflow modelling, intra-group dependency and wind-down trigger calibration.
- Firms should consider the impact liquidity needs in wind-down have on their assessment of resource adequacy, their risk appetite and point of non-viability.
- Testing the outcomes of wind-down planning is the best way of showing the firm's Board/ governing body, as well as the FCA that the plan and process is credible and operable.

Next steps

1.5 In this review we reiterate some of our expectations (see WDPG and FG20/1) and share observations of firms' actual practice. These examples and observations are being provided to help firms with their continued work on wind-down planning, in complying with existing policy requirements and should be read together with any other relevant guidance.

1.6 While the exercise was conducted in response to the COVID-19 pandemic the observations within this review may be relevant to all firms regardless of the broader economic environment.

1.7 Firms can choose to incorporate these observations into their own wind-down planning. Should they wish to apply these observations, they should do so in a way that is proportionate to the nature, scale, and complexity of its own activities. It is important that firms consider these observations, as we may take these elements into consideration when performing a review of wind-down plans at a future date.

2 Broader context and existing FCA expectations

Overview of the exercise

2.1 In light of the COVID-19 crisis and the stresses this introduced, we examined wind-down preparedness of some of the largest firms across several markets, focusing on liquidity. This was based on our experience that a lack of liquidity is a significant driver of harm during wind-down.

2.2 Firms have an obligation under Threshold Condition: COND 2.4 to hold adequate financial and non-financial resources, including liquidity. We have further outlined in FG20/1 the importance of a good understanding of cash flows in stressed circumstances for an orderly wind-down and the reduction of harm. FG20/1 explicitly states that part of the role of adequate financial resources is to enable an orderly wind-down.

2.3 The FCA's exercise involved:

- bi-lateral discussions with firms on their assessment of a) cashflow needs during wind-down; b) modelling methodology; c) pre-wind-down risks which could reduce the firms starting cash balance; and d) intra-group reliance
- reviewing general wind-down plan documentation

2.4 Following this engagement, we gave feedback for firms to incorporate into their wind-down procedures, and we encouraged many firms to hold additional liquidity specifically for the purposes of wind-down. Our exercise resulted in firms reaching a better understanding of our existing guidance, as well as the firm's own cash need for wind-down.

2.5 The following observations relate to wind-down liquidity, reflecting the narrow scope of our exercise, and do not reflect our broader view on wind-down planning outside of this scope. Firms should consider this note in conjunction with the FCA's broader guidance on wind-down planning.

2.6 We encourage all firms to review the Wind-Down Planning Guidance (WDPG) section of the FCA handbook and FG20/1, in addition to the specific points raised in this paper, and consider whether any changes need to be made to the firm's wind-down planning process. These should all be considered proportionately in line with a firm's nature, size and complexity.

Approach to wind-down planning and liquidity

2.7 We expect all wind-down plans to be credible, operable, and to minimise harm. To achieve this, firms must ensure the availability of sufficient financial and non-financial resources during the wind-down process. We recognise that part of the purpose of financial resources is to ensure an orderly wind-down, and a firm should consider whether its financial resource assessment reflects this. Firms should embed

wind-down planning into their risk management framework, recognising that disorderly wind-down is a key driver of harm. Firms are best placed to identify what is required to make their wind-down planning credible and operable. We have observed that 'testing' of the wind-down plan is necessary to show its operability and credibility to the firm's Board.

2.8 Where a firm is a part of a Group, it may choose to complete wind-down planning as a Group, so long as planning adequately covers each individual, regulated firm within the Group. An entity level view ensures the firm's Board as well as the FCA are sighted on some of the complexities which can exist within the Groups winding down. There is no definition of 'adequate coverage', but we have observed that this can include:

- Governance – eg what are the role and responsibilities of the Boards and ExCo's of each legal entity, and how do these interact across the Group
- Operational Plan – how will each entity be wound down, the implications of a partial wind down, where some entities continue and others wind down
- impact assessment – particularly the assessment of harm.

Wind-down planning should also consider the impact of non-regulated entities, as this may have an impact on the regulated entity. While it is up to firms what approach they take to ensuring all regulated entities are covered by wind-down planning and procedures, whether at Group level or entity level, the firm must ensure that they are operable and credible, with interactions across legal entities clearly documented in the Wind-Down Plan document.

2.9 It is up to each firm how they choose to structure their wind-down planning documentation, considering the activities, size and complexity of their business. We use firm's wind-down planning procedures and documentation as part of assessing whether a firm is holding adequate financial resources. If the wind-down planning documentation does not allow us to make that assessment we may direct a firm to take action to remediate any shortcomings.

2.10 To support firms' continued development of their wind-down planning we are sharing our observations from our recent exercise in this document. This is not an exhaustive list and there may be other common issues with wind-down plans which were not in scope for this exercise.

3 Key Observations

Liquidity in wind-down

3.1 During wind-down a firm must continue to pay its liabilities as they fall due, a failure to do so could push the firm into a disorderly wind-down or an insolvency process. We have seen that firms often consider capital needs in their wind-down plans but do not consider liquidity. A firm should consider how its cash position may change during the wind-down period, and plan accordingly. Planning typically includes the cash paid out to complete the wind-down process, temporary cash outflows which can result from an orderly transition eg trade settlement, and finally considering what cash may be received during wind-down, such as residual revenue and from the sale of assets. When taken collectively, this tells a firm what cash is required to ensure the wind-down process is orderly. We expect a firm to consider whether its liquid holdings would be sufficient to fund a wind-down, if it were to happen.

Holding liquidity for orderly wind-down

3.2 Every firm authorised under the Financial Services and Markets Act 2000 (FSMA) must meet threshold conditions, requiring firms to have appropriate resources (see COND 2.4). This includes during the wind-down period, while a firm maintains its part 4A permissions.

3.3 During our discussions with firms, we encouraged many of them to hold a pool of liquidity specifically to fund wind-down, or at least to fund the initial stages where there may be large outflows and significant cashflow mismatches. We encourage firms to consider whether a defined pool is needed to ensure that the firm has adequate financial resources for an orderly wind-down.

3.4 To ensure the availability of sufficient cash at the point of wind-down, we saw the following good practice:

- Holding 'ring-fenced' liquidity explicitly for the purposes of wind-down, separate from other existing liquidity requirements.
- Prudently quantifying the liquidity which must be held in non-stress environments to ensure adequate liquidity would be available, should wind-down occur.
- Putting controls in-place to ensure funds segregated or ring-fenced for liquidity can only be used following Board approval.
- Ensuring the segregated account is not subject to any right of set-off. A right of set-off may exist if the firm is a recipient of financing from a bank. In this situation, the bank may have the right to use all the firm's bank deposits (a right of set-off) as collateral or security against the financing facility, even if the firm's liquidity for wind-down is held in a separate account at the same bank.

3.5 We have observed that liquidity issues arising during a wind-down can be broadly categorised in 3 ways, and all 3 should be considered when quantifying the liquidity required during wind-down:

- cashflow timing mismatches
- net cash impact of wind-down
- starting wind-down from an already stressed cash position

Cashflow timing mismatches

3.6 Firms must have the ability to fund any temporary mismatches which occur during wind-down, some of which can be very significant for certain business models. We have observed that even though a firm may be net cash positive over the entire wind-down period, it can experience significant cash timing mismatches during wind-down. As an example, investment brokers may be responsible for funding temporary mismatches arising from facilitating the end of clients trading activity, where there may be several days gap between the timing of funds paid out to clients and those received from exchanges or counterparties.

3.7 In addition, many firms projected a structurally negative cashflow during wind-down, due to reduced revenue and increased costs. We saw that firms did not adequately consider that selling assets may take longer than its cash reserves can fund its operations.

3.8 The lack of consideration during wind-down planning means firms are often unsighted on any potential cash shortfall at different points-in-time during the wind-down period, potentially under-estimating the overall liquidity required during wind-down. Funding mismatches can be made more difficult due to the likely withdrawal of overdraft and other financing facilities which the firm would typically have access to in non-stressed environments. Taken collectively, firms should consider what financial resources may be required to fund these temporary periods.

3.9 It is important that firms take into account a reasonable time horizon such that it is operationally possible to wind-down in an orderly manner and therefore quantifying the liquidity required to fund the wind-down can be accurately projected. Mapping the entire liquidity trajectory of inflows and outflows of the firm over this wind-down period can help identify periods of mismatches and liquidity shortfalls. See **approach to quantifying liquidity for orderly wind-down** below and **Chart 1**.

Net cash impact of wind-down

3.10 Firms should assess the net cash impact of wind-down. That means assessing whether the firm is likely to be net cash positive or negative at the end of wind-down once the total cost of wind-down and the realisable value of its assets are taken into account. It is important to note that the net cash position is different to the net capital impact of wind-down. Even if a wind-down results in a capital reduction, it may still be that wind-down is net cash positive (cash accretive), if, for example, the firm has residual cash inflows from pre-existing books of business, and it can quickly downsize its operations, leaving a residual cash generative book of assets.

3.11 We have often seen firms misidentify or miscalculate wind-down specific costs. This impacts the assessment of the level of liquidity required to meet those costs.

Cash balance at wind-down commencement

3.12 Finally, we have observed that many firms did not consider the potential impact a wind-down scenario may have on their starting cash balance, that is, the cash balance the firm has at the start of wind-down. Many firms assumed in their wind-down plans that they will enter wind-down with either their current cash balance and liquidity holdings, or a cash balance broadly in-line with their risk appetite. We have observed that, for some firms, liquidity is a major risk and may be a cause of wind-down. We observed good practice was to consider what the wind-down starting cash position may be in different scenarios, and to assume some level of cash stress before the start of wind-down. This helped inform firms assessment of whether their BAU and wind-down starting cash position was adequate to ensure that any temporary and net cash needs over the full wind-down period could be met.

Approach to quantifying liquidity for orderly wind-down

3.13 To ensure adequate liquidity is available at the point of wind-down firms may need to complete granular cashflow modelling exercises. We saw that many firms completed a brief analysis which lacked the detail we would expect. This created a risk that the firm may have a bigger wind-down liquidity need than suggested by its analysis. The immature state of some firms' wind-down plans meant that they reverted to a more simplistic methodology to calculate wind-down liquidity needs, using the firm's Fixed Overhead Requirement (FOR) as a proxy. This may have resulted in the estimated resource need being higher (or lower) than a more sophisticated approach would yield.

3.14 We observed the following good practice at firms in their modelling of cashflows:

- Considering a scenario(s) and the subsequent financial position the firm would be in prior to a wind-down being invoked by the firm's Board, ie assuming that the cash position is reduced prior to wind-down.
- Setting out the gross inflows and outflows likely to be experienced across a wind-down period (see **Table 1**), using appropriate underlying assumptions.
- Calculating the flows on a sufficiently granular basis considering the nature of the business activities eg day by day and week by week over the entirety of the wind-down period. This enabled firms' boards to see flows in and out of the business over time, and identify any periods with a net shortfall in available liquidity.
- Calculating the total funding impact at the end of the wind-down period.

3.15 **Chart 1** and **Table 1** below show an illustrative example of Business-as-Usual (BAU) and wind-down specific inflows and outflows over a hypothetical wind-down implementation period. We observed that the specific timing of flows depend on the firm's business model, contractual agreements, and its operational capacity.

3.16 Creating such tables and charts can help a firm identify cash mismatches, the net cash impact, and consequently its cash position at different points-in-time over the wind-down period. We saw that some firms broke out their cashflows into separate BAU and wind-down specific cashflows, to help reviewers understand how cashflows may change during a wind-down period. We also saw that some firms extended the analysis to cover the entire wind-down period, but with decreasing granularity over time, given that peak mismatches are likely to occur early in the wind-down period. While it varied between firms, generally this resulted in daily cashflow forecasting for the first 2 weeks of the wind-down period, with weekly from week 2 to the end

of month 3, and then monthly cashflows from the end of month 3 until the end of wind-down. We have seen that granular analysis of this type was useful in mapping outflows that would occur in the early stages of the wind-down and subsequently actions that the firm would need to take to prevent mismatches and conduct an orderly wind-down.

3.17 We saw that firms with robust modelling of its wind-down cashflows, were those with good underlying liquidity stress testing capabilities, given the overlap in data sets and modelling capabilities.

3.18 The following were some examples of good practice:

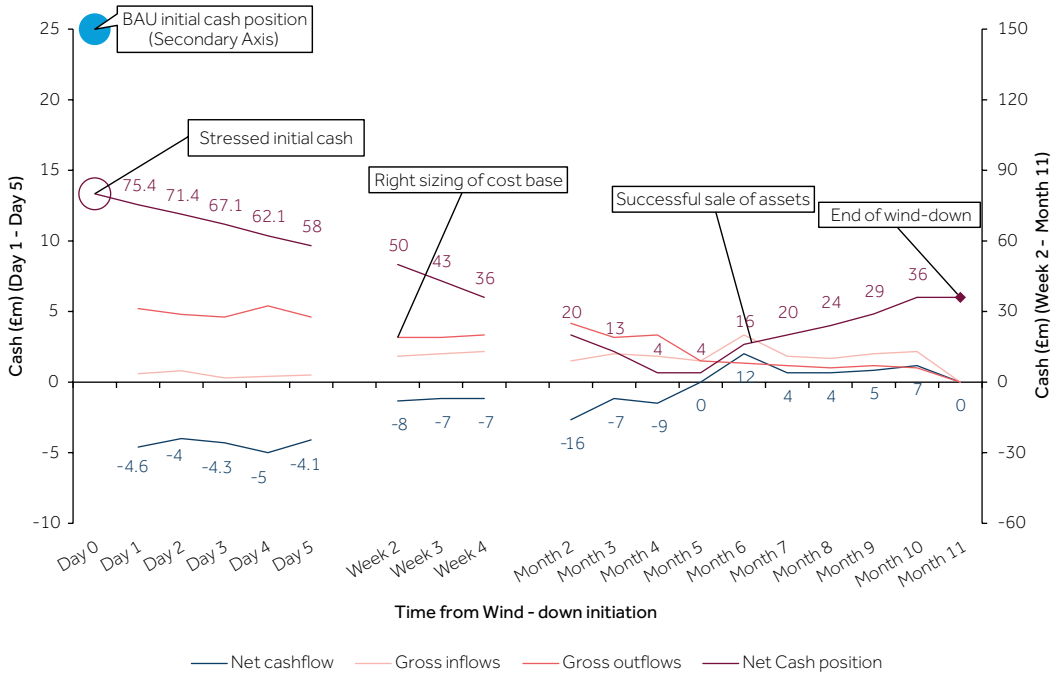
- Identifying and documenting every type of cashflow line item, including what data points feed into them, and the underlying assumptions for each line item. While some aggregation may be helpful in presenting the information to the Board, we observed that good practice was for a very granular underlying cashflow model, which was then summarised.
- Separating BAU cashflows from wind-down specific cashflows, to support firms' Board members in understanding and assessing the validity of the cashflows and underlying assumptions.
- Using one of the wind-down scenarios as a backdrop to the cashflow modelling, to inform some of the behavioural and other assumptions for each of the cashflow line items.
- Presenting the outputs of the model in such a way as to be understandable to senior management and the Board.
- Considering and challenging some of the underlying behavioural assumptions informing the cashflows:
  - Clients are likely to be more cautious, eg reducing the level of funds held with the firm.
  - Finance providers are likely to withdraw facilities.
  - Creditors are likely to become more demanding.
  - Debtors may become more reluctant to pay, delaying receipts.
  - Staff may leave, creating operational challenges around cashflow management, and the potential need for expensive cover arrangements.
- When modelling cash inflows, taking a conservative approach to each cash inflow, assessing its credibility in wind-down, for example:
  - New revenue is likely to be reduced by wind-down.
  - Revenues from residual and historic business may be largely unaffected.
  - Other contractually guaranteed inflows, eg trade settlement.
  - Returned collateral as trading activity reduces.
  - Natural cash generative reductions in back books of business eg a loan-book.
  - Proceeds of any restructuring, eg asset sales.
- In assessing the BAU liquidity needs and cash outflows, considering:
  - Contractually required outflows.
  - BAU business expenses, such as salaries and third-party payments.
  - Intra-group fees and service costs.
  - Completing any pipeline of business, eg the firm may be committed to a loan at the point of wind-down and is contractually obliged to provide the loan.
  - Settlement of trades.
- In assessing the wind-down specific liquidity needs and cash outflows, considering:

- Retention bonuses to be paid to required staff.
- Redundancy costs.
- Professional fees.
- Behavioural changes to counterparties and central clearers, such as increased collateral calls and reduced flexibility over the timing of payments.
- Withdrawal of funding facilities which may need to be repaid.
- Withdrawal of client funds and trading activity, which can result in temporary (several days) liquidity mismatches for the firm depending on its trade settlement process.
- Crystallisation of liquidity risks during the wind-down period.

3.19 Below is a hypothetical example of what a firm's cash position over time might look like through a wind-down:

Example net cashflow during wind-down

Chart 1: A hypothetical example of a firm's cashflow during wind-down. Some of these timings can vary significantly depending on business model.



Note: Primary vertical axis represents Cash levels from Day 1 to Day 5. Secondary vertical axis represents Cash levels from Week 2 onwards.

Table 1: Table corresponding to the chart above.

Flows Experienced over the Period		Day 0 to Day 5	Week 2 – Week 4	Month 2 – Month 11
Starting liquid Assets		Cash available at the start of the wind-down. You should assume that you have experienced outflows prior to the start of the wind-down.		
A) Inflows	**A1) BAU Inflows**			
	Trade Settlement Existing pipeline of business	This should include all contractually gauranteed inflows subject to any wind-down expected impact. E.g clients cancelling deals once wind-down is announced.		
	A2) Wind-down specific inflows			
	Wind-down of business activity, e.g. reduced trading activity resulting in returned margin Natural decline of loanbook Proceeds of business sales or other transactions	Inflows which will only occur in the event of a wind-down, the most material of which is likely to be any inflows resulting from reducing new business activity and sales of assets.		During this period, there will likely be a spike in inflows reflecting successful sale of assets
	A3) Total Inflows	**Total inflows over each period**		
B) Outflows	**B1) BAU Outflows**			
	Trade settlement Existing pipeline of business Operating costs, inc. staff costs, service, paying for intra-group services fulfilment	This should include all contractually gauranteed outflows subject to any potential wind-down impact. E.g reduced business activity and reduction of business pipeline, leading to reduced BAU flows	The firm arrives at a reduced cost base for the wind-down period	
	B2) Wind-down specific outflows			
	Retention bonuses Professional fees Increased margin requirement Repayment of all financing contigency funds for outflows e.g. fines, client redress etc. cost of cancelling contracts Cost of failed trades and closing out positions	Outflows which will occur in the event of a wind-down, the most material of which are likely to be retention and professional fees for small firms, margin payments for trading firms, repayment of financing for some lenders Traders will be concentrating on closing out principal positions and resolving failed trades in the first two weeks of the wind down.		Firm completes negotiations with counterparties over the outstanding failed trades and makes payments as agreed.
	B3) Total outflows	**Total outflows over each period**		

C) Net Liquidity Flows	**Net change in liquidity under BAU**	The BAU expected change in liquidity if the firm was not in wind-down. **A1 MINUS B1**
	Net change in liquidity caused by wind-down specific actions	The net flows as a result of wind-down specific actions **A2 MINUS B2**
	Total net change in liquidity	The total net change in liquidity day by day, or period by period caused by BAU and wind-down specfic inflows and outflows. **A3 MINUS B3**

Intragroup dependencies

3.20 For many UK firms within Groups, we saw inadequate consideration of the impact of Group membership on the UK firm's ability to wind-down. Our Guidance in FG20/1 encourages firms to consider the impact a firm's membership in a Group has on its assessment of its wind-down resource requirements. Many firms have interpreted this in solely a positive way, that is, the benefits group membership can have for a firm but have not considered the stress caused by interconnectivity, for example, parental failure.

3.21 Intra-group interconnectivity is where the operations or activities of the UK firm involves financial or non-financial resources from other legal entities within the wider group. For example, having a Group HR function which provides cross-Group support, having intra-group financing arrangements, or using a Group IT system which is hosted and run out of another legal entity. For many UK firms, interconnectivity is fundamental to their operating model, which can create complexity in a wind-down. Indeed, many firms explicitly stated in their wind-down plans that an orderly wind-down is dependent on group solvency and support. For firms with significant intra-group dependency and inter-connectivity, this results in the wider group becoming a single point of vulnerability for the UK regulated entity.

3.22 Intra-group reliance generally falls under the following categories:

- Financial inter-connectedness, eg intra-group funding, booking model, income flows / allocation.
- Operational inter-connectedness, eg dependence on group IT, or group owning the relationship with external providers.
- Contingent financial support, eg parental guarantees, or access to group financing facilities.

3.23 FG20/1 makes clear that firms must be able to wind-down in an orderly manner, regardless of the scenario which causes the wind-down including failure of the group. Firms should therefore assess what interconnectivities exist, assess the impact of these on their wind-down capability and consider what mitigating actions can be taken. Firms should consider what operational and financial resources are required within the Firm or Group's control for them to wind-down in an orderly and self-sufficient manner. Where firms have a reliance on group entities in wind-down, firms should plan for how this inter-connectedness would be unwound during a wind-down, or what alternative arrangements can be put in-place now to mitigate the reliance.

3.24 We have seen that this is an area of weakness in firms wind-down planning, particularly firms with overseas Groups, where the UK Board may have little to no ability to impact

the decision making of other group entities or its parent. Many firms have made little to no consideration of how to manage intra-group dependencies during wind-down. This creates significant risks that any scenario involving financial or operational pressure on the Group, may result in a disorderly failure of the UK regulated entity.

3.25 To mitigate intra-group reliance, some firms considered how interdependencies could be unwound or replaced during a wind-down, however we observed that often such measures are not credible. Often measures must be taken while the firm is in a business-as-usual state to ensure such mitigating measures will have sufficient time and resources to be completed successfully. For example, where the Group owns relationships with third parties, some firms assessed how to novate contracts to the UK entity in the event of a Group failure. Our assessment was that due to the significant time taken and significant resources required to novate third party contracts, it was unlikely to be credible to do this activity during a wind-down. The firm therefore needed to consider what it could do, while in a steady state, to mitigate its dependence on its Group third party relationship ownership.

3.26 We observed some firms established a Group Service Company (ServCo). A Group ServCo typically owns third party contracts, employs all staff, and has its own financial resources. This can ensure that even if other legal entities within the group, or indeed the entire group itself, fails in a disorderly manner, the ServCo can continue to provide services to each group entity, and existing eg contractual relationships will not immediately end.

3.27 The Group ServCo, if implemented correctly, can mitigate interconnectivity concerns and ensure continuity of service during wind-down. Due to the central importance of interconnectivity to many firms operating model, it is often not credible to undo such arrangements in BAU and implementing mitigation measures for each interconnectivity may be prohibitively expensive. We have observed that some businesses have identified operational benefits to establishing a Group ServCo. However, this may not be suitable for all business models as establishing a ServCo does come with its own risks. Firms can perform an analysis to consider whether implementing this into their own operations would benefit their wind-down planning and procedures.

3.28 We saw the following good practice:

- Mapping out the list of existing interconnectivities with the group, and then considering the interconnectivities during a wind-down. Identifying all interconnectivity requires a granular mapping exercise to understand the activities involved with all business and operational processes; the resources which underpinned those processes; and where those resources come from. For example, where an IT system is used, considering which entity owns the system, whether there is local capability to run and maintain the system, and whether it is hosted on servers under the control of the UK entity. This granular mapping exercise provides a basis for all further work on interconnectivity. We observed that some firms found efficiencies by leveraging operational resilience work and associated mapping.
- Assessing the impact each point of interconnectivity has on the firm's ability to wind-down. This typically involved understanding the operational steps to wind-down, and using the granular mapping exercise to inform what resources situated where within the group are required to complete a wind-down. Once complete, firms then

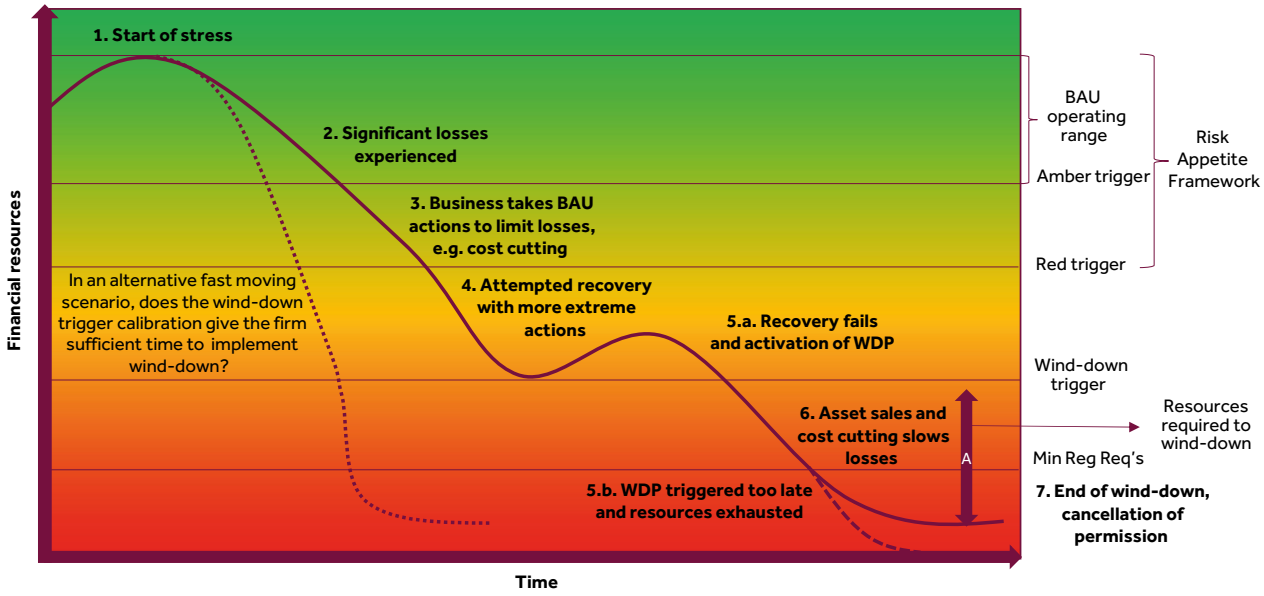
completed an impact assessment of each dependent, with some firms using a bucketed approach, ie high, medium, and low impact dependencies.

- Independent and adequately skilled governance of the UK entities. This means ensuring that the entity is able to independently understand and plan for any operational changes which may occur, and to ensure they have a 'voice' at Group level. Specifically, the UK Board has sufficient capability and credibility to ensure that the operating model of the UK entity is appropriate and that they are involved in the design of cross-Group operating model changes. Having mechanisms to oversee the performance and enforcement of intra-group contracts, and a dispute resolution mechanism in the event of contract underperformance.
- Assessing the credibility of each mitigation measure and setting out the time and resources required to implement. This analysis supported the Board's decision as to which actions could wait until wind-down commences, and which should be implemented now to ensure the firm is prepared for wind-down.

Wind-down triggers

3.29 Wind-down triggers are an essential part of wind-down planning. They should be designed such that the firm enters wind-down at a point where it will have sufficient financial and operational resources to complete an orderly wind-down. Wind-down triggers should be considered as an initiation point for the firm to act and consider whether wind-down is required. We observed that many firms failed to consider an appropriate range of wind-down trigger metrics (eg capital resources) and the calibration of the wind-down triggers was not justified. Failure to create adequate wind-down triggers lead to wind-down decisions occurring only late in a stress, at the point when financial or non-financial resources may be reduced and time to respond is scarce, limiting the Board's options. Wind-down triggers should be closely linked to the firm's risk management frameworks and be monitored closely particularly during times of stress. A sound risk management and controls framework should allow firms and their senior management to identify, understand, manage, monitor and mitigate the risk of potential harm caused to consumers and markets. Senior managers should have clear lines of responsibility for adequate systems and controls, including winddown planning. We observed that short-comings in wind-down triggers sometimes indicated broader issues with firm's risk management and risk appetite frameworks.

Chart 2: Illustrative example of how wind-down triggers support an orderly wind-down. Appropriately calibrated triggers ensure adequate financial and non-financial resources are available at the point of wind-down to make it orderly, and the firm has time to take appropriate actions.



3.30 We have observed that this was an area of weakness for firms, and specifically:

- No consideration of an actual wind-down trigger. Firms did not consider a quantitative threshold which could trigger a wind-down, instead relying on qualitative statements. Quantitative wind-down triggers put the onus on the Board to demonstrate that the firm does not need to wind-down at that point-in-time, and may encourage a more conservative approach to invoking wind-down.
- A disconnect between wind-down triggers and the firm's BAU risk appetite. Given a wind-down is likely to result from a crystallisation of the firm's risks, we would typically expect to see a wind-down trigger being a more extreme calibration of the firms existing risk appetite metrics.
- Firms did not chart the impact of its wind-down scenarios, showing how the risk appetite metrics change over the course of the stress (for example in the style above), making it difficult for the Board to see whether the triggers would be hit sufficiently early in the stress for it to act.
- Wind-down triggers calibrated with no reference to the financial resources required to complete a wind-down and therefore had no certainty that wind-down will be triggered early enough in a stress that financial resources will still be available for wind-down.

3.31 We saw that firms did the following to show that they are holding adequate resources:

- They considered an appropriate range of triggers, which reflect the risks of the firm and the potential causes of harm, for example, and are consistent with the firm's existing risk appetite framework.
- They completed granular reverse stress testing, so that the firm understands its business model vulnerabilities, and has identified triggers which reflect these vulnerabilities.

- They considered how triggers interact, and what the interaction of triggers tells the firm about the nature of the stress and whether wind-down is required.
- They completed stress testing and reverse stress testing to inform the assessment of the firm's risk capacity, its point of non-viability, and consequently its risk appetite calibration, and wind-down trigger calibration.
- Forward-looking triggers were included, eg cash forecast, forecast operational capabilities, etc.
- Triggers reflected the financial resources required to successfully complete a wind-down, eg, if the firm needs £5m of cash to complete its wind-down, the firm should consider winding down once it reaches that cash threshold.
- They considered what additional information may be required to inform the decisions throughout the wind-down process, for example invocation of wind-down; the sale of business units; staff redundancies, etc.
- They incorporated the triggers into regular Management Information reports, ensuring that triggers are monitored and tracked regularly.
- They used quantitative triggers which are thresholds which, once reached, trigger a decision point for the Board to consider whether to wind-down.

4 Next Steps

4.1 Firms may find it helpful to consider our observations when carrying out their own wind-down planning. Many firms would benefit from integrating their wind-down planning process with their Risk Management Framework and financial resource adequacy assessment. We also observed that firms may benefit from considering the cash needs during wind-down, as shown by the table above, and whether the firm needs to hold additional liquidity in BAU to ensure that any wind-down is orderly.

4.2 We encourage all firms to read this review and would be happy to discuss our observations further. If you have specific queries, please contact wd-liquidity@fca.org.uk.

Annex 1
Business model specific observations

1. This exercise was conducted across a wide range of portfolios and business models. We share in greater detail below our observations from two business models: Non-Bank Lenders and Investment Brokers. We believe these may be of assistance to a variety of firms in their wind-down planning and are in addition to our broader observations above.

2. All firms would benefit from reviewing these sections and thinking about risks they share and do not share with these specified business models to assist in their own thinking.

Non-Bank Lenders

3. We observed that Non-Bank Lenders (NBLs) were generally net cash accretive over the wind-down period. However, they still experienced periods of net cash outflows typically early in the wind-down period. This meant that they required some residual cash at the point of wind-down, to ensure the firm did not run out of cash and therefore the firm entering an insolvency process.

4. Due to Covid-19, NBLs have faced a difficult operating environment. In particular, NBLs were faced with a loss of funding through the securitisation market and loss of income due to Covid payment deferrals and increased arrears. In some cases, the loss of funding meant an inability to fund new lending and therefore a further loss of income via origination fees. While they could make use of the Covid furlough scheme, NBLs were not eligible for the Bank of England's TFSME scheme which was only available to banks and building societies.

5. We observed that firms rapidly adjusted their business models to manage demand for lending, provided customers with payment deferrals, preserved equity and headroom under loan facilities, and refinanced debt and negotiated additional lending from wholesale banks and the capital markets where possible. NBLs do not have access to Bank of England liquidity schemes, and many are not able to participate in government lending schemes. This has placed significant pressures on them and shows the importance of firms giving due consideration to the contingency funding and wind-down plan.

Cash inflows:

- Non-Bank Lenders (NBLs) typically receive cash inflows from loan administration and from the underlying loan book assets. We observed that firms treated the inflows from administration as very secure even in a stressed scenario because they have high priority of payment insulating them from deteriorating credit quality of the loans, while there were some scenario specific variation in inflows from loan books which depend on the performance of the loans and the seniority of the credit exposure held by the firms.

- NBLs typically included some residual revenues from their loan book in their predicted cash inflows during wind-down. We observed that NBLs often assumed a haircut reflecting a conservative assumption that the performance of the back-book in a wind-down scenario will be below BAU estimates.
- NBLs often fund their lending initially through warehouse facilities with the ultimate goal of securitisation. NBLs are exposed to the most junior credit exposure arising from the structure of the warehouse facility and they are also required to retain a minimum 5% exposure to the securitisations issued using their loans as collateral. The risk retention does not have to be to the most junior notes, but in practice it often is. The NBL will receive interest income on both types of exposures but it will be diminished or fully curtailed if the credit quality of the loans deteriorates beyond certain levels, which is more likely in a wind-down scenario.
- NBLs expected the back book of business to be highly saleable, given the relatively liquid loan book market in the UK, with several firms having had prior experience of completing loan book sales in the past. Firms had varying expectations for the time to execute a sale, often dependent on the preparatory work which had already taken place. While asset sales may be credible, we observed that these would be completed towards the end of the wind-down period and likely at a discounted price, with cash outflows continuing in the interim, this results in a temporary cash mismatch and reinforces the importance of assessing the temporary cash needs prior to asset sales being completed (refer to the comment below on the impact of substitution).

Cash outflows:

- We observed that the recent experiences of NBLs during the COVID crisis shown their ability to rapidly cut costs, where deferrals in interest payments required significant rapid cost cutting, typically focused on new lending, administrative, and other central staff. We observed that many of them used similar assumptions in their wind-down plans to justify their cost cutting estimates.
- Warehouse facilities used for new loan origination prior to securitisation come with various covenants and triggers designed to protect the senior lenders providing the majority of the funding, while the NBL provides the junior funding. In normal circumstances where the NBL wishes to keep those facilities available they will be required to top up collateral in the structure if covenants or triggers are breached. In a wind-down we can expect that no new lending will occur beyond the pipeline of existing commitments and that the warehouse facilities will be wound down also. This may occur as a result of deterioration of the credit performance of the loan book such that a liquidation event or event of default is triggered which results in a forced sale of the assets. NBLs would need to consider any additional outflows which might be required as a result of the wind-down of the warehouse facilities.
- We also observed that where there was a reliance on intra-group funding facilities, a conservative assumption was taken such funding facilities may become unavailable in a wind-down scenario, potentially representing a significant outflow. We observed that some firms discounted the availability of group-held facilities and encourage all firms to assess financial resource requirements on a solo entity basis.
- It is important to note that other business models may have a waiver granted to them by the FCA such that it allows for liquidity to be managed on a group basis and therefore it may make sense for them to consider additional liquidity that could be received in such scenarios.

Net cash impact:

- Given the cash flows we observed above, typically NBLs expected to be net cash positive at the end of wind-down. However, a NBL's liquid resources are likely to be at the lowest point in the cycle when the exposures created through warehouse financing are at a high level shortly before a planned securitisation transaction. Firms with enhanced wind-down planning capabilities were able to incorporate this into their wind-down planning and document management actions they would pursue if the firm became unable to meet its liabilities as they fall due. This was done in the form of modelling cashflow after management actions such as cutting costs. We observed that NBLs were typically month-on-month cash negative unless there was a significant cash inflow eg from a successful sale of a book of assets or from loan administration fees
- However, we did observe that this did not mean firms were cash positive during the whole of the wind-down period. Many firms still expected there to be net cash mismatches at different points in-time during the wind-down period. In particular during month 1 of the wind-down period, when retention payments, professional fees, and redundancy payments would all come due. Sales of loan books raised against warehouse facilities seem more likely to be finalised further into the wind-down process.
- Given the above, firms may benefit from considering in detail the cashflows during wind-down, to identify any potential pinch points, and how the firms starting cash position may change depending on where firms are in the securitisation cycle.

Investment Brokers

6. For the majority of brokers' wind-down period, cashflows are fairly predictable given that wind-down costs typically arise from staff retention, redundancy payments, advisory expenses and ongoing overheads. However, significant mismatches can occur during normal operations and during wind-down, hence the importance of considering liquidity in the wind-down plan.

7. Brokers typically make money through fees and commissions charged to perform every action on their platform such as placing a trade. Other brokers make money by marking up the prices of the assets they allow you to trade or by taking the other side of client trades. As a result of excess volatility in the market due to Covid-19, Trading firms have typically seen an increase in revenues.

Cash inflows:

- Typically, brokers have seen an increase in fees & commissions due to market volatility causing record levels of orders, transactions and messaging during the pandemic
- During a wind-down, a trading firm would not have many different types of inflows. They may see a large cash inflow at the start or at the end of the wind-down period. This could be from the likes of (considering haircuts):
  - Temporary balances resulting from client trade settlement or position close-out
  - Liquidity rebate receivables
  - Sale of exchange memberships and seats
  - Proceeds of asset sales

Cash outflows

- Normal operating costs, also called the burn rate which is the total cash position divided by monthly losses (adjusted for non-cash items), typically occur in the run up to a wind-down and should be considered within firms' wind-down planning. This is typically done by incorporating losses in firms' stress testing. We have seen that the burn rate reduces over-time as expected.
- For much of the wind-down period, predictable operational expenses remain throughout wind-down, including:
  - Advisory fees (legal and liquidators)
  - IT and third-party expenses
  - Ongoing staff costs and retention bonus'
  - Ongoing office costs
- Firms often used stress testing to stress their cashflows in order to get sight of what the firm's position would look like in a
- There are significant outflows during the earlier period of the stress as firms have to pay margin; refund excess client deposits; refinance where financing facilities are removed; and others
- This led to many firms identifying week 1 as the time period with the most significant cashflow mismatches

Net cash Impact:

- These firms tend not to be net cash accretive at the end of the wind-down period
- We observed sometimes very significant temporary cash mismatches in the first month of the stress, due to a reduction in client activity

Risks to orderly wind-down:

- Investment Brokers can typically wind down their business quickly given that most of them can stop taking orders immediately. The biggest risk to firms' orderly wind-down is cashflow mismatching. This can take form in multiple ways.
  - Cross-Currency Liquidity Risk: There may be a situation where funding facilities are in a foreign currency, but if that currency is depreciating, they may need to use more domestic currency to fund outflows.
  - Funding Risk – some firms may rely on uncommitted credit facilities for funding. During times of stress, the institution providing the facilities may pull the use of the facility and so, firms may be required to search for alternative sources of funding, often at more expensive rates.
  - Intra-group reliance – discussed in detail above.

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