Teneo

Solvent Wind-Down Plans and the Regulatory Agenda

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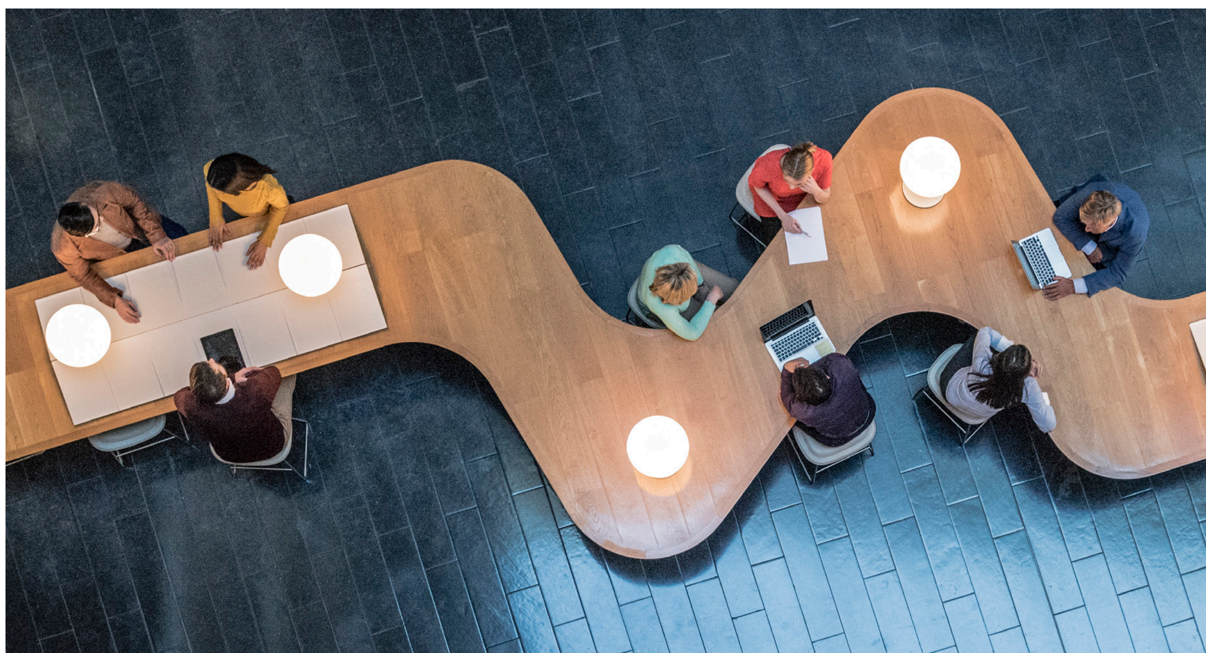

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Last summer, we released an article about the growing focus on solvent wind-down plans ("SWDPs") by financial services regulators. For those unfamiliar with SWDPs and keen to learn more about what they are, who needs one and why, please read the article: **Why are Savvy Financial Services Directors of Stable and Growing Firms Talking About Solvent Wind-Down Plans?**[1]

SWDPs remain an important and growing aspect of the regulatory agenda and in this article we focus on recent regulatory messaging and why it is worth spending the time bringing SWDPs up to scratch.

Financial Conduct Authority Thematic Review

In April 2022, the FCA published a thematic review covering their observations on wind-down planning[2].

[1] https://www.teneo.com/why-are-savvy-financial-services-directors-of-stable-and-growing-firms-talking-about-solvent-wind-down-plans
[2] "Observations on wind-down planning: liquidity, triggers & intragroup dependencies" TR22/1, April 2022. https://www.fca.org.uk/publication/thematic-reviews/tr22-1.pdf

This review examined the wind-down preparedness of a selection of the largest regulated firms. Although it was prompted by the stresses introduced by COVID-19, it is arguably relevant to all regulated firms regardless of the broader economic climate or size of firm.

The overall finding of this review was that many firms do not have documented plans that would enable them to wind-down solvently should that become necessary. These firms do not have a sufficiently developed, financially sound and practically executable wind-down plan in place. They would be unable to trigger a wind-down quickly enough to ensure that a disorderly or insolvent wind-down is avoided. In short, most plans fall short of expectations.

This finding is entirely consistent with our own observations and experience. In our view, firms are slowly but increasingly looking to rectify this situation, as doing so can not only reduce regulatory scrutiny but also increase business confidence from both customers and investors. There are a few factors within the thematic review that are useful to highlight as key areas of focus for this remediation:

- **Liquidity**

  Firms often consider capital needs within their SWDP without considering liquidity. Whilst it may sound obvious, having sufficient liquidity at all points of a wind-down is critical to avoid an insolvent outcome.

  Cashflow timing mismatches are a typical driver of liquidity stress, resulting from short term liabilities being due in a wind-down before illiquid assets can be converted to cash. The FCA therefore encourages firms to hold a pool of liquidity specifically to fund a wind-down, at least in the initial stages, to mitigate this liquidity risk and to undertake detailed cashflow planning for wind-down to ensure that the plan is as robust as possible.

  In our experience, liquidity is the most commonly mis-forecast and mis-planned element of a wind-down. Practical stressors are rarely applied to liquidity. For example, a common real-world stressor is that an illiquid asset takes longer to sell than planned, leading to the possibility that the firm becomes cashflow insolvent in the interim.

- **Net assets**

  Firms often look at their balance sheet net assets as their financial position on wind-down commencement. This is effectively their “fuel in the tank” to fund a wind-down to conclusion. However, the balance sheet is prepared on a going concern basis and at an artificial snapshot in time. It may look very different in a wind-down scenario. In our experience, we regularly see assumptions in a wind-down that overestimate the position. For example, firms may assume that all assets on the balance sheet (including intangible assets, office equipment etc) will be realised for value over time, assume that off-balance sheet liabilities do not arise (e.g., contractual exit costs or litigation costs) and assume that key staff do not require incentives during a wind-down to stay the course. This can leave firms with insufficient funds to complete a wind-down solvently. They will not have enough fuel in the tank to reach their destination.

- **Wind-down trigger**

  It is critical for a successful wind-down that the wind-down is triggered before an insolvent exit becomes unavoidable. The FCA has highlighted that many firms fail to

put in place “an appropriate range of wind-down trigger metrics.”[3] Our experience is similar, with few firms having a clear path between entering a period of distress and triggering a wind-down. Even a robust and viable plan will not work if it is not triggered on time, as a continued cash burn will eat into the net asset position.

Overall, our view is that if a SWDP includes appropriate liquidity planning and net assets are assessed on the basis of likely realisable values, then a SWDP is more likely to be viable. The overall viability of a plan, however, is predicated on appropriate triggers being in place and the expectation that boards will trigger a SWDP before it becomes too late. If, under a wind-down scenario, at the point the trigger is pulled there are sufficient net assets and there is sufficient liquidity availability throughout the wind down to match the cash requirement, then capital planning becomes somewhat redundant.

Regulatory Changes

As of 1 January 2022, the Investment Firms Prudential Regime (“IFPR”) came into force. This is a new prudential regime that covers all FCA Markets in Financial Instruments Directive (“MiFID”) investment firms. Whilst there are widespread changes resulting in a single prudential regime for all FCA investment firms, it is interesting to note that there is a heavy focus on recovery and wind-down. In particular, one of the goals that IFPR seeks to achieve, and covers in detail, is to ensure that an “orderly market exit (including wind-down) of an investment firm”[4] could be achieved at any point should that be required.

To achieve these goals, the IFPR establishes the internal capital adequacy and risk assessment (“ICARA”) process. This is the collective term for the “internal systems and controls that a firm must operate to identify and manage potential material harms that may arise from the operation of its business, and to ensure that its operations can be wound down in an orderly manner.”[5] All firms within the perimeter of IFPR will therefore have to consider wind-down planning as a core part of this process and will have to incorporate this into their financial planning. The concept of an Overall Financial Adequacy Rule (“OFAR”)[6] requires firms to hold sufficient own funds, in sufficiently liquid form, to allow the firm to be wound-down in an orderly way.

As firms get to grips with this new regulatory requirement, it is anticipated that the natural outcome will be greater consideration of SWDPs and how they can be proportionately considered within each business.

Conclusion

It is likely that the regulatory pressure to have an effective SWDP in place is going to increase over time. Further measures, like those set out in the IFPR, will probably be extended to a broader range of firms. Firms that do not engage are likely to come under greater scrutiny. We can already see regulators taking steps to ensure that SWDPs are credible, appropriately costed and executable. Whilst historically regulators have used their powers sparingly in respect to SWDPs, in recent times we have seen the use of powers under the Financial Services and Markets Act 2000 (“FSMA”) to compel firms to act through Skilled

[3] “Observations on wind-down planning: liquidity, triggers & intragroup dependencies” TR22/1, April 2022. https://www.fca.org.uk/publication/thematic-reviews/tr22-1.pdf
[4] “Implementation of Investment Firms Prudential Regime” PS21/17, November 2021. https://www.fca.org.uk/publication/policy/ps21-17.pdf
[5] 7.4.8G(2), Investment Firms Prudential Regime Instrument 2021. https://www.handbook.fca.org.uk/instrument/2021/FCA_2021_38.pdf
[6] MIFIDPRU 7.4.7R(1)

Persons reviews. The FCA has also explicitly stated recently that they “may use our powers to prevent harm from occurring, for example, by preventing the firm from continuing to carry on regulated activity.”[7] Therefore, wind-down considerations and governance should be on the agenda for any regulated firm and many will have to remediate their SWDPs to address the common deficiencies, albeit in a realistic and proportionate way. Ultimately, a sound plan with well defined triggers will be important for all firm directors, as this not only demonstrates strong governance but also provides protection during times of distress.

[7] “Implementation of Investment Firms Prudential Regime” PS21/9, July 2021. https://www.fca.org.uk/publication/policy/ps21-9.pdf

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