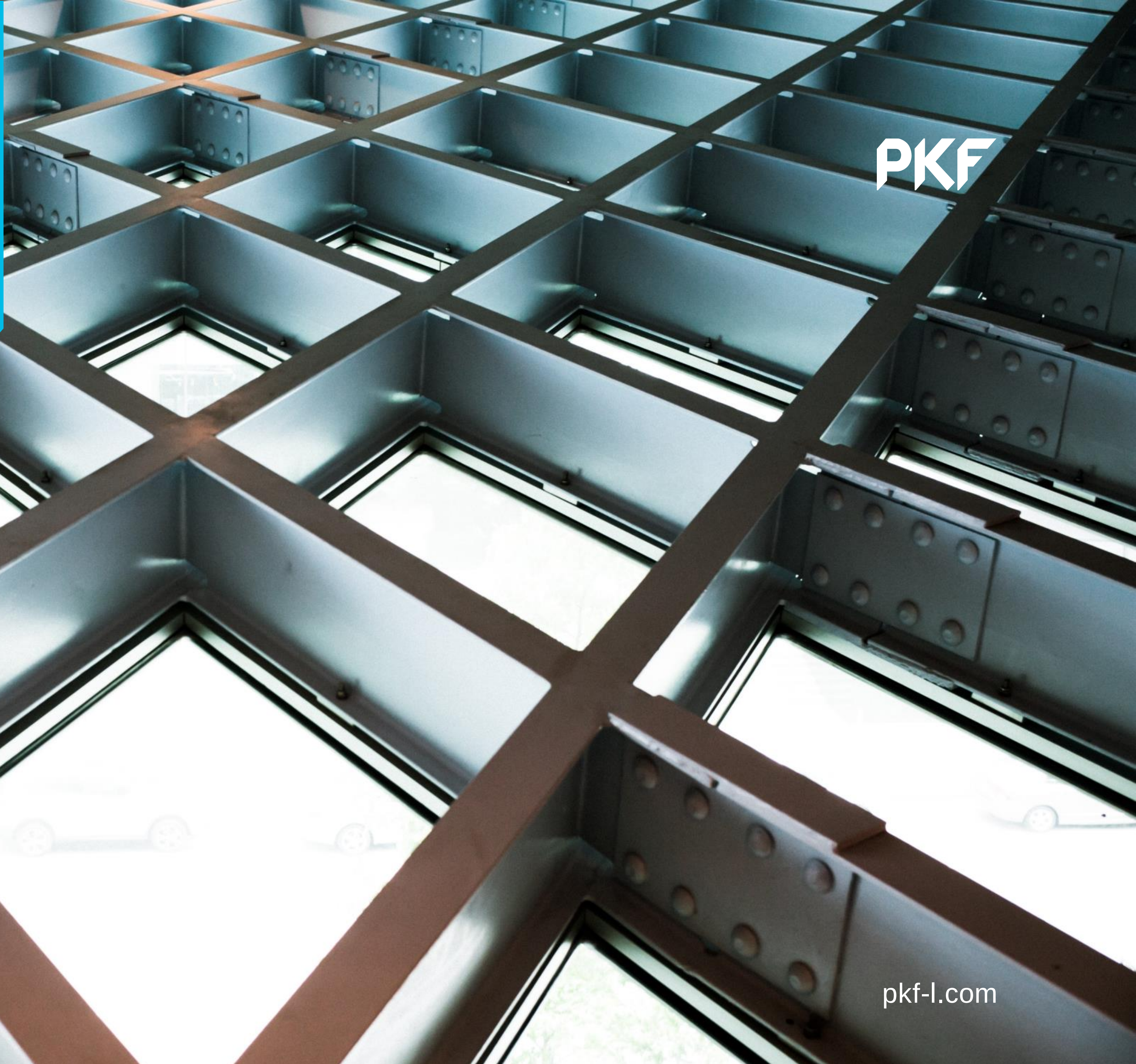
Broking Breakfast:

Sharing the shortcomings in wind down planning, and delving into CASS 5 hot topics

20 February 2024



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01 Introduction
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02 Wind Down planning
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03 CASS 5
Tom Herne

04 Closing and Q&A
Paul Goldwin

February 2024

FCA Regulation & Wind-Down Planning - Are You Prepared?

Paul Goldwin

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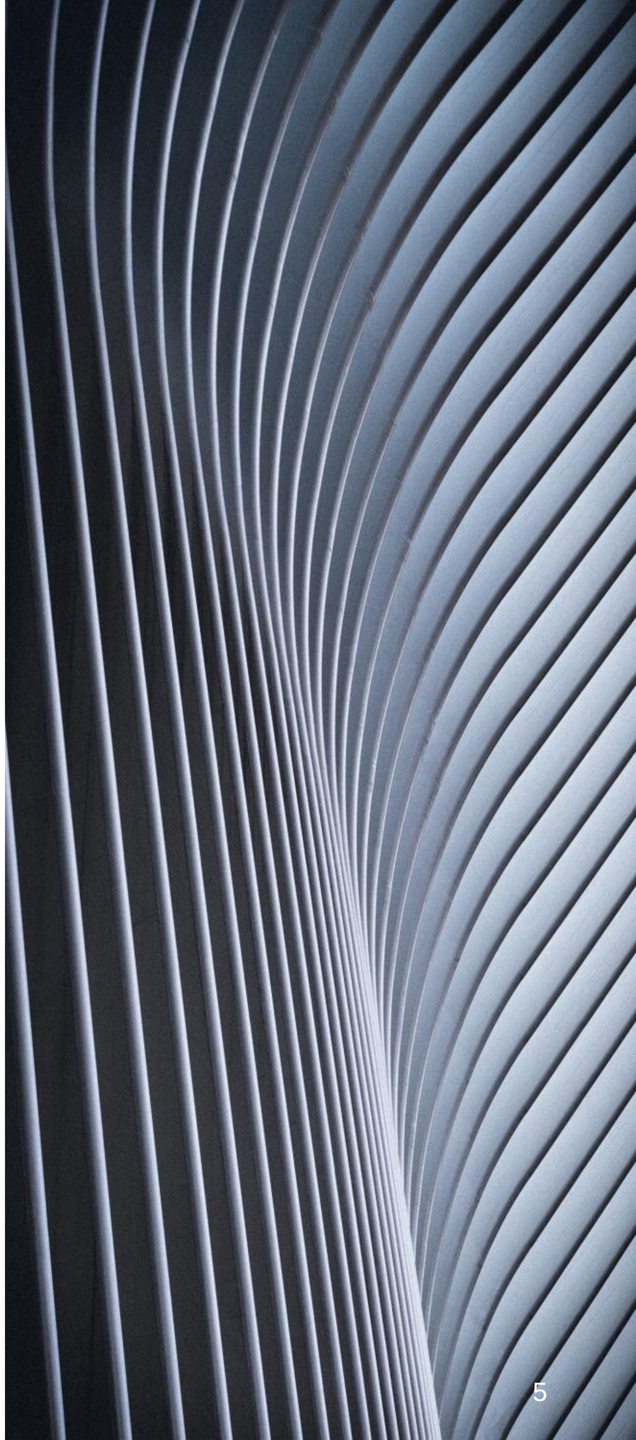

Emergence of Wind-Down Planning (WDP) as Regulatory Concept

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- WDP been around for a while as regulatory concept, initial FCA guidance 2016
- WDP became FCA ‘hot topic’ during COVID, due to concerns over firms’ financial resilience
- FCA’s WDP guidance re-issued June 2020, refreshed August 2021 and more recently August 2023 - still very much on regulator’s radar
- WDP embedded as regulatory priority for some time - ‘Financial Resilience and Resolution’ – an ‘overarching priority’ in 2021/22 Business Plan
- Latest FCA 2023/24 Business - ‘FCA’s continued focus on reducing harm from a firm’s failure’ - goes to the heart of WDP

FCA Guidance/Interaction with Threshold Condition 2.4 (TC 2.4)

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- Original WDP guidance in 2016 – latest version incorporates very useful ‘*Quick Reference Guide*’ (Appendices 1-12) to help solo-regulated firms put WDP theory into practice

- FCA reminds firms of the need to comply with TC 2.4 throughout period of wind-down, ensuring firms have ‘adequate financial and non-financial resources’

  - Sufficient ‘capital’ and ‘liquidity’ during wind-down process to enable orderly wind-down, without running out and having adverse impact on other stakeholders

  - Access to adequate ‘non-financial resources’, such as personnel, IT infrastructure, professional advice etc, during run-off to ensure wind-down progresses as planned

- FCA Principle 4 (PRIN 2.1) – FCA requires all firms to comply with general FCA rules and ‘threshold conditions’ during its time as a regulated entity and to enable an orderly wind-down (throughout wind-down period)

Wind-Down Plans - General Principles

Wind-Down Plans - General Principles

- A WDP is a formal document which aims to enable a firm to cease its regulated activities and achieve a cancellation of its regulatory permissions with no adverse impact/harm on its clients, counterparties or wider market
- Compulsory and applies to **ALL** regulated firms, not just those in financial distress, also those seeking a strategic exit from the market
- No set template or proforma - needs to be tailored to firm's own circumstances - refer to FCA Quick Reference Guide
- Applies to all FCA solo-regulated firms authorised with Part IVA permission
- Does not apply to firms already in administration or liquidation (liquidators will have own plans with creditors etc)

Wind-Down Plans - General Principles

- Living document - refreshed periodically, particularly where significant changes in business
- Credible, up-to-date, comprehensive and operable
- In practice will include:
  - Financial projections/cash-flow modelling with detailed assumptions covering wind-down period and identifying TC 2.4 buffer required to wind-down
  - Detailed practical narrative plan, setting out in detail how the orderly wind-down will be achieved
- Formal document - integral part of firm’s governance process - needs buy-in of Board of Directors (not just an ‘accounting task’ for Finance Department)
- End game is cancellation of Part IV A permissions - FCA will not cancel permissions until satisfied that orderly wind-down has been completed

What Constitutes a Good Wind-Down Plan?

What Constitutes a Good Wind-Down Plan?

- No right or wrong way of preparing a WDP - needs to achieve end game of demonstrating regulated firm's exit from market in orderly manner without causing harm to customers, the wider market or other stakeholders

- Key elements:

Business background	Overview of business areas and business model to provide context
Risk management framework	Overview of entity's risk management framework, covering process for monitoring risk and relevant wind-down triggers and thresholds
Governance	Explanation of ownership of WDP document, mechanisms in place to invoke plan, details of governance arrangements surrounding wind-down process

What Constitutes a Good Wind-Down Plan?

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Wind-down triggers/ scenarios

Prepared using ‘stressed’ scenario. Evaluation of various potential wind-down triggers and explanation as to why final wind-down trigger has been selected

FCA expects firms to model different triggers (although chosen trigger will form basis of plan) and understand operational differences and implications for wind-down arising from each

Impact assessment

Assessment of potential harms that could befall different stakeholder groups from wind-down/firm’s plans in place to minimise impact of such harm

Operational analysis

Narrative explanation of step-by-step key activities to wind-down across all areas

What Constitutes a Good Wind-Down Plan?

Resource assessment

Detailed analysis of financial and non-financial resources required to execute WDP - following impact assessment and operational analysis

Typically combines narrative plan with detailed cash flow analysis and underlying assumptions, demonstrating how TC 2.4 buffer is maintained at all times

Communication plan

Plan setting out communication strategy with different stakeholder groups and how managed throughout wind-down process

Important so that key stakeholders, such as remaining employees, IT infrastructure providers, professional advisers, remain on-side during wind-down process to facilitate successful wind-down

Group inter-dependencies

Assessment of group inter-dependencies (if applicable) and how risks have been mitigated in the WDP

FCA Thematic Review - TR 22/1 - Observations on Wind-Down Planning

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- FCA carried out thematic review on WDP, as well as a more general multi-firm review in September 2022, which included 10 GI insurance intermediaries (London market/commercial GI brokers)
- Where they existed, and in many cases they did not, WDPs were at an early stage of maturity, with substantial gaps
- Most WDPs required significant work to meet FCA's minimum standards and were at 'an early stage of maturity'
- Significant work required to make wind-down plans credible and operable
- There were some examples of good practice, but most showed room for improvement

FCA Thematic Review - TR 22/1 - Observations on Wind-Down Planning

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Key Findings/Weaknesses

- **Liquidity**
  - Firms good at monitoring capital needs, less good at monitoring liquidity needs
  - Firms need to demonstrate how TC 2.4 buffer is 'ring-fenced' - be it in designated accounts, availability of draw-down funds etc
  - Impact of cash flow timing mismatches between cash flow inflows and outflows in WDP
  - Better handle of 'net cash impact' during wind-down period, maintaining a positive cash flow throughout
  - Ensure healthy cash balance at start of wind-down period to avoid entering process in state of financial distress
  - Firms need greater granularity of detail in cash flow modelling exercise, avoiding over-simplistic approaches
  - Firms need to consider behavioural assumptions surrounding wind-down process, as different from 'business as usual' approach - for example retention bonus for staff, creditors may become more demanding, debtors may become more cautious, IT suppliers may require up-front funds to continue doing business

FCA Thematic Review - TR 22/1 - Observations on Wind-Down Planning

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Key Findings/Weaknesses

- **Intra-Group Dependencies**
  - FCA permits WDP on a group basis, provided an ‘entity view’ is available for each regulated entity
  - FCA review saw inadequate consideration of impact of group membership on UK firm’s ability to wind-down
  - Although can be a positive, firms failed to consider potential stress caused by interconnectivity
  - Inter-connectivity arises where operations of UK regulated firm involve financial or non-financial resources from other legal entities, such as group HR function, IT system run from another legal entity
  - FCA believes that for firms with significant intra-group dependency and inter-connectivity, results in wider group becoming point of vulnerability for UK regulated entity (as decision-making not fully under its control)

FCA Thematic Review - TR 22/1 - Observations on Wind-Down Planning

Key Findings/Weaknesses

- **Intra-Group Dependencies**
  - Intra-group reliance can be:
    - Financial inter-connectedness, eg intra-group funding
    - Operational inter-connectedness, eg dependence on group IT **or** group having the relationship with key suppliers
    - Contingent financial support, eg parental guarantees **or** group financing facilities
  - FCA found a lack of assessment of:
    - Inter-connectedness that existed in WDPs
    - Impact of these on capability to wind-down
    - Mitigating action taken to minimise risk

FCA Thematic Review - TR 22/1 - Observations on Wind-Down Planning

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Key Findings/Weaknesses

- **Wind-Down Triggers**
  - FCA noticed a failure to identify and act on well thought out trigger, being credible initiation point for WDP
  - Firms failed to consider range of potential triggers and therefore through lack of planning, would be ill-prepared if wind-down arose due to alternative triggers
  - Regulator failed to see close link between chosen trigger and firm's risk registers
  - Some firms did not identify a wind-down trigger at all
  - Inadequate correlation between wind-down trigger and actual financial resources required to complete the wind-down

What do we see in Practice?

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- Not all firms have a WDP and many still believe that it does not apply to them
- Many firms have prepared a WDP based on complex financial/cash-flow modelling, but lack a ‘narrative plan’ to tell the story of how the wind-down will take place operationally
- Firms do not pay sufficient attention to the wind-down trigger, a ‘this cannot possibly apply to us’ attitude
- WDPs often mistaken for Business Continuity Plans
- WDPs prepared by Finance Department as part of a ‘tick box’ exercise, with insufficient buy-in from senior management
- Poor financial modelling in some cases with over-simplistic assumptions, not conducive to an ‘operable, realistic and credible’ model as required by FCA
- Many WDPs that we see are not ‘fit for purpose’

What next from the FCA?

What next from the FCA?

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- Following results from thematic review and multi-firm review, FCA have stated that they will continue engaging with the GI market on WDP until 2025 at least
- FCA very likely to deviate from current ‘soft approach’, encouraging firms to consider their own WDP arrangements with FCA findings, to a harder and stricter enforcement based approach
- Given FCA’s emphasis on financial resilience, it is clear to them that this remains an area of weakness and concern for them and will move higher up the regulatory radar
- Likelihood of much greater level of regulatory intervention where FCA deems firm’s wind-down planning to be deficient - possibility of imposing capital additional requirements (as seen in investment management firms) or delaying authorisation process (as seen with electronic money institutions)
- Other regulators taking note, indicating that a market-wide issue of great importance, eg PRA for non-systemic banks and EU regulators (eg BAFIN)
- Are you prepared? Ensure you are

How can PKF help?

How can PKF help?

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CASS 5 hot topics to consider for 2024

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Agenda

01 Client money calculations

02 Client by client reconciliation

03 CASS 5 Risk and Controls Matrix

04 Credit writebacks

05 Consolidators and transfers of books of business

06 Statutory trust to Non-statutory trust

Client money calculations

Client money calculations (CMCs)

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FCA continue to see non-compliant calculations – extensively reported in CASS 5 opinions

Usually an issue of excluding insurance related balances

Focus on understanding of system generated reports and reliance on external data such as bank statements

Mid-month transfers not supported by a CMC

Use of realised or earned brokerage reports to inform early withdrawals

Permitted when required but must follow a properly completed client money calculation.

Client by client reconciliation

Client by client reconciliation and funding

- Continued focus on the insolvency mindset and is still a common breach we identify
- Use of the client by client reconciliation to evidence of ability to distribute client money but also to monitor funded balances.
- FCA has an increased interest in bad debt provisioning and, in particular, funded bad debt
- FCA expect robust evidence of recoverability for aged balances to support any unprovided balances.
- Remain vigilant on funding from statutory trust environments – use of the client by client reconciliation.

Risk and Controls Matrix

Risk and Controls Matrix

Firms are required to have in place a CASS Risk mapping document which sets out the CASS rules applicable to the firm and the controls that the firm has in place to ensure that it complies with those rules

Consideration of whether the controls are working as expected

Expectation for this to be reviewed on an annual basis

Not a specific breach as set out in the CASS rules, but following discussions with FCA, they consider not having this as a breach of the 'Client Money organisational arrangements' (Principle 10) and therefore expects auditors to include as breach.

Credit Writebacks

Credit writebacks

- Viewed as an indicator of weak financial resilience by the FCA.
- Seeing more incidence of credit writebacks in the market.
- Highest concern for credit writebacks of any balances created in the last 3-5 years.
- Consider CWBs to be a breach of fiduciary duties in protecting client money and a potential breach of trust law.
- There are differing legal opinions and legal advice should be obtained to justify any credit writebacks

Credit writebacks

- Expect only instances to be where express consent has been received from the entity to write off the balance
- Firms are applying ‘deemed consent’ rather than ‘actual consent’ in effecting a credit writeback
- Even in this case the FCA would expect the firm to pay away the monies to charity rather than retain for the business.
- Expect any credit writeback approval to be minuted at an appropriate level with consideration of legal implications.
- Formal credit writeback policy outlining the steps taken
- Take proper legal advice to establish that the credit writeback doesn’t breach trust law.

Consolidators and Transfers of books of business

Consolidators

- FCA welcomes consolidators as notes that they are keen to ensure that the correct processes and procedures around client money are in place

- Role in reducing the risk and quantity of smaller non-compliant brokers in the market

- FCA keen, however, to ensure monies are transferred correctly reducing risk of poor customer outcomes

- Risk where consolidators move CASS funds from acquired entity to own CASS accounts – sometimes increasing risk profile if moving from ST to NST environment.

- Similar to credit writebacks – seen by the regulator as another area where the importance of trust status is being misunderstood.

Consolidators – transfers of client money

- Transfers between trust environments as a breach of trust law
- FCA keen to ensure that relevant consent obtained from clients who have been properly informed – and usually requires up to 85% consent prior to applying for waiver
- Key here being the consent must actual consent rather than deemed consent
- Difficult to obtain consent quickly – now more commonly see this communicated through consumer TOBAs
- We recommend considering the ability to obtain appropriate consent prior to any transfer of client money
- Best practice to transfer the book, run off the balances and close the client money account

Consolidators – ST to NST

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Same 85% consent required prior to applying for waiver to move from statutory to non-statutory trust

Clear requirements to meet CASS 5.4 – Non-statutory client money trust

- Appropriate systems and controls
- Appointment of a client money manager
- Signed trust deed
- Adequate resources – Higher of £50,000 or 5% regulated revenue of regulatory capital for business with retail clients
- Procedures in place to manage credit risk arising from the operation of the NST

Require an auditor's letter to confirm the adequacy of systems and controls in respect of the NST environment.

FCA view the failure to obtain an NST letter as a serious matter and expect a letter to be available for review throughout the year

FCA now requesting firms to move to an ST to reduce risk for consumers where an NST letter is not in place.

Hot topic takeaways

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Client money calculations and client by client reconciliation

- Review your understanding of how the system generates data used in reconciliations
- Ensure completeness of balances included

Risk and Controls Matrix

- Prepare and maintain to demonstrate robust systems and controls
- Review annually to ensure details are current

Credit writebacks

- Consider deemed or actual consent before effecting any credit writeback
- Obtain appropriate legal advice to establish that the credit writeback doesn’t breach trust law

Consolidation and change in environment

- Consider if communication to consumers and consent is appropriate before any transfer
- Keep in mind implications for trust law compliance

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