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Trading Activity Wind-Down (TWD)

Point of View

MAKING AN IMPACT THAT MATTERS since 1845

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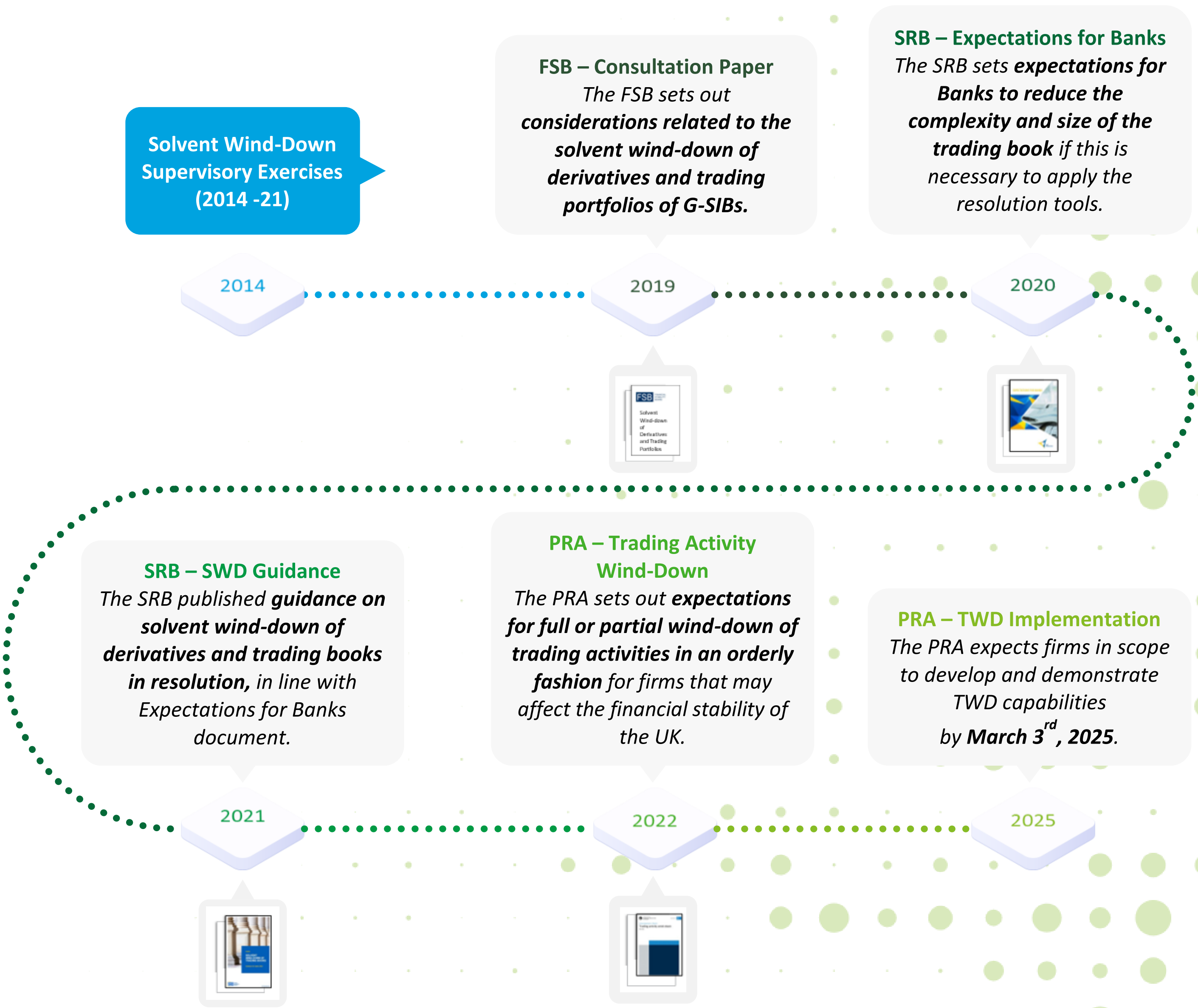
Instead of seeing TWD as another regulatory hurdle to overcome, firms should view the PRA's TWD expectations as a catalyst and opportunity to drive change end-to-end. These expectations provide the toolkit for senior management to better understand their trading portfolios, underlying risks, financial and operational ramifications associated with their portfolios.

INTRODUCTION

This article showcases Deloitte's Point of View (PoV) on PRA's expectations around the Trading Activity Wind-down (TWD), which has been consolidated based on our regulatory insights and experience in supporting wind-down programmes for various clients, ranging from UK, European and international banks. Here, we present the key considerations for firms when planning for TWD compliance as well the biggest challenges being faced. Lastly, our PoV covers the areas where firms should be focusing their efforts on for the next two years to enhance capabilities and highlights how developing a TWD solution could be beneficial in business as usual (BAU).

BACKGROUND AND REGULATORY LANDSCAPE

For a number of years, regulators in the US and UK have required several systemically important banks to conduct solvent wind-down (SWD) exercises, covering both trading and non-trading book exposures, as a part of wider recovery and resolution preparedness. These SWD exercises were carried out between 2014 – 2021 and results confirmed that firms lack the capability to wind-down trading activities in an orderly manner. This has been the cornerstone for the PRA to publish the Consultation Paper CP20/21 'Trading activity wind-down' that formed the basis of final TWD guidance in May 2022[1]. The scale of a major bank's trading book, and more importantly the interconnectivity with other market participants, means a disorderly wind-down during recovery or resolution event would pose a significant risk to the Bank of England's financial stability objectives. This has also been an area of focus for the Financial Stability Board (FSB) and the Single Resolution Board (SRB) for a number of years now. Evolution of regulation around the trading activities can be seen below:



[1] Following initial consultation with the banks who participated in the PRA SWD Information Requests, the PRA finalised and published the Trading Activity Wind-Down (TWD) Policy (Statement of Policy (SoP) 'Trading activity wind-down and Supervisory Statement (SS) 1/22 'Trading activity wind-down'). The PRA also released the Policy Statement (PS) that provided feedback to responses to Consultation Paper 'CP20/21 Trading activity wind-down'

WHAT IS TRADING ACTIVITY WIND-DOWN (TWD)?

Trading Activity Wind-down (TWD) is a regulatory priority, where the PRA expects firms that may affect financial stability of the UK[2] to develop and demonstrate capabilities that will allow them to execute full or partial wind-down of trading activities in an orderly fashion, by 3rd March 2025. Firms are also expected to develop or enhance their existing playbooks and highlight current implementation plans including planned testing and simulation exercises.

The wind-down of trading activities, whether full or partial, or whether it would be carried out as a recovery or post-resolution restructuring option, is referred to as 'the TWD Option'. TWD Option is referred to the set of actions that firms will carry out in order to stabilise their capital or liquidity positions, minimise liabilities or limit impacts on financial stability when winding down their trading activities. This typically consists of segmenting the trading book into portfolios of positions with similar risk profiles, for example FX exotic derivatives, articulating a disposal strategy for each portfolio i.e. auction, transfer to third party or novation, early termination and associated exit, hedging and operational costs, reporting on the bank's capital and liquidity positions, articulating of all assumptions in the analysis, and describing the remaining "rump" assets that will persist after the wind-down period.

Developing and maintaining the firm's recovery plan and resolution pack is a prescribed responsibility (PR) under the Senior Managers Regime. The maintenance of TWD capabilities and of the TWD Option also falls under this PR. The TWD Option needs to be included as one of the recovery options in the recovery plan and firms should use their TWD capabilities to help develop their recovery plan and Business Reorganisation Plan (BRP).

[2] The new policy applies to firms meeting all the following conditions:

a. PRA designated Other systemically important institutions **('O-SIIs')** that have either **full or partial wind-down** of their trading activities as a **recovery and post-resolution restructuring option;** and
b. their preferred resolution strategy is **Bank-led bail-in** or they are **considered a material entity** of an overseas group for internal MREL purposes and are expected to meet these new PRA expectations

PRA TWD EXPECTATIONS

The PRA sets out the following expectations around core capabilities required to develop and execute the TWD Option:

CORE CAPABILITIES

Information provision and decision-making capabilities

- Produce information and data at sufficient granularity, including information to **support segmentation of trading portfolios in multiple ways [Formal TWD templates – Quantitative & Qualitative analysis]**
- **Project Exit Costs, Operational Costs, Capital Resource Impacts and Requirements, Liquidity and Funding and Risk-based Losses** from the assumed reference date throughout the wind-down period
- **Sensitivity analysis –** quantify the impact of alternative key assumptions to those assumed under the TWD scenario
- **Rump Analysis –** to include exit cost estimates for discretionary rump positions
- **Intra-group analysis** including inter-affiliate risks

Refresh capabilities

DATA REFRESH – refresh below data in a 'matter of DAYS'

- **Balance sheet & risk data** (including data on trading book positions at the individual contract, collateral and asset levels), liquidity resources, and contractual liquidity flows
- Quantification of **wind-down costs** including re-hedging costs
- **Capital and liquidity projections**

FULL PLAN REFRESH – refresh material components of the TWD option, including changes to assumptions, modelling, methodology and changes to factors that make up TWD scenario **'within WEEKS'**

Controls

Appropriate cross-referencing and reconciliation to other business-as-usual data sources such as regulatory reporting data

OTHER EXPECTATIONS

TWD Scenario

- Scenario of severe macroeconomic and idiosyncratic stress
- Should include minimum baseline set of factors such as duration of market-wide stress, holding period, credit downgrades, barriers to OTC markets / sale of portfolios, secured funding markets / FX markets access
- At least one of the four scenarios used in the recovery plan should be used to develop and test the TWD Option
- Firms should be able to update scenario when stress occurs within weeks using 'full plan refresh' so that it reflects live market conditions

Sensitivity Analysis

Ability to perform sensitivity analyses of the key market factors set out in the TWD scenario, assumptions, and judgements that could have a material impact on capital and liquidity projections and on RBLs. At a minimum, sensitivities of capital and liquidity to the following factors should be included:

- *duration of market-wide stress;*
- *severity of credit downgrade of the TWD firm, and severity of general credit downgrade as part of the macroeconomic scenario;*
- *barriers to OTC derivative market access;*
- *barriers to the sale of portfolios during market-wide stress;*
- *full or partial closure of secured funding markets and foreign exchange markets;*
- *market calibration inputs such as input parameters for the exit cost calculations;*
- *shifting the relative prioritisation of capital resource maintenance vs liquidity maintenance vs risk reduction;*
- *increasing or reducing the targeted wind-down period;*
- *applying different segmentations of portfolios for the purpose of novation to step-in counterparties;*
- *partial wind-down: TWD firms should be able to quantify the impact on the projections of removing portfolios from the wind-down; and*
- *risk appetite for the discretionary rump, for example the likely cost of closing out discretionary rump positions within the active wind-down period*

Firms are also expected to build and maintain the capabilities to produce the data in the below TWD Templates:

TEMPLATE REF	TEMPLATE NAME	TEMPLATE COMPONENTS
A	**Exit Costs**	Segmentation definition, segmentation metrics, exit strategies, exit costs – hedging costs, exit costs – exit discounts, timing of exit costs and liquidity Flows
B	**Operational Costs**	Total operational costs (direct costs / recharges), remote booking costs, real estate costs, FMI costs
C	**Unencumbered Assets**	C1 - unencumbered and encumbered current / spot collateral positions as at the reference date C2 - unencumbered collateral positions only at the reference date and at the liquidity low point
D	**Capital Analysis**	Capital resources, RWA, leverage, MREL, capital requirements, capital ratios, changes in retained earnings
E	**Liquidity Analysis**	Part A – securities flows / cash flows and end of day balances Part B – LCR projections

TWD EXPECTATIONS - KEY CONSIDERATIONS IN OUR VIEW

TWD templates

- Rather than having the mindset of just completing the TWD templates to meet regulatory obligations, firms should understand how this information can help them understand their trading book better, how it supports a wind-down and associated costs / risks / financial and operational intricacies, and how it fits in with broader recovery and restructuring strategy. Consideration should also be given to additional MI that would be required to support such a view and will aid decision-making by firm's senior management, the PRA, and the Bank of England (BoE).
- Reliance should also be placed on existing reports that could be leveraged for TWD e.g. PRA 110.
- Firms should prepare the templates on basis of future regulations for e.g. Basel 3.1 / FRTB, these could have a material impact on both market structure and strategies due to their bearing on capital projections, which is a key component of the TWD Option. Careful planning is required as the implementation date for these overlap with the TWD implementation timeline and same resources would likely be required to meet these competing expectations.
- In addition, new models or significant enhancements to existing models would be required to meet the Basel 3.1 / FRTB expectations. Firms should validate their models in aggregate and identify any interdependencies between these models and where these will be used to meet TWD capabilities.

Refresh capabilities

- Firms should make use of most recent data available in BAU where possible to reflect the changes in trading activity. However, in cases where this is not possible firms should consider the costs and benefits of updating BAU processes to capture daily numbers e.g. daily RWA vs use of reasonable quantification techniques to capture the moves accurately from the last refresh date.
- Although firms are encouraged to use their existing stress test capabilities (e.g. ICAAP stress testing) in designing and testing the TWD scenario, they need to be cognisant of the refresh times when tweaking the scenario to adapt to prevailing market conditions during live stress. Capabilities and modelling should be dynamic enough to meet the PRA refresh times.
- Although the PRA has not specified the duration expectations for 'data refresh' and 'full plan refresh' it would be reasonable to assume these to be 'within five days' and 'within four weeks' respectively, in line with the SRB guidance on 'Solvent Wind-Down of Trading Books'[3] and previous SWD / VIR refresh expectations.

Sensitivity analysis and system flexibility

In addition to the robustness of the TWD solutions, flexibility should be a key consideration when designing these so these are capable of performing and testing sensitivity analyses around the key drivers, assumptions and judgements which could have a material impact on capital and liquidity projections. The PRA has provided a list of minimum factors that firms should consider in SS1/22 4.49. This is not an exhaustive list and firms should also account for elements of their TWD plan that could drive material differences to capital and liquidity forecasts in a live stress.

[3] 2021-12-01_Solvent-wind-down-guidance-for-banks.pdf (europa.eu)

TWD scenario
Firms should aim to achieve alignment between the recovery planning scenarios and chosen TWD scenario from the start. The TWD scenario should not only include the baseline factors the PRA has provided but also account for the macroeconomic shocks that can be configured quickly to meet the refresh requirements. This is proving to be challenging for some firms as their existing recovery planning scenarios do not account for all the factors the PRA has asked to consider in SS1/22. In our view, this would require some thought and work on choosing an existing severe stress testing scenario and tweaking it to fit in the TWD parameterisation.

Risk based losses (RBLs)
There is also limited guidance in SS1/22 on estimating RBLs, but it does set out the overall expectations in relation to estimating losses arising from credit, market, and operational risks. Though not explicitly stated in the TWD guidance, firms should also include loss estimates from CVA risk.

There is also a clear lack of understanding and industry consensus on how to calculate RBLs. Some firms are aiming for precision and looking to use XVA engines, whereas others are planning to use VAR / SVAR approaches. Firms are not expected to develop complex modelling (such as market-driven risk changes and trading behaviour throughout the wind-down period) to calculate RBLs. The PRA encourages firms to leverage and adapt existing risk measures such as BAU stress losses and the projected capital requirements using their own judgement to derive an appropriate level of insight into the potential magnitude of losses e.g. apply scalars to appropriate BAU stress number to capture differences between the BAU and TWD scenarios.

Exit costs

Capital valuation adjustment (KVA)
Most firms are using hurdle rates and do not currently model KVAs as part of their BAU derivatives pricing. We have seen the PRA emphasising the need to model KVA over the last few years. In our view, this tends to be a material component of exit costs for firms with large derivatives positions and firms should start thinking how to model this.

Other valuation adjustments
Firms should leverage existing prudent valuation capabilities to ensure numbers reported for TWD analysis can be reconciled to regulatory or internal reporting.

Liquidity analysis
The BoE identified the inability to forecast unencumbered collateral as the key shortcoming in the recent RAF Assessment findings for the UK banks. Hence, firms need to focus their attention on building capabilities that will enable them to identify, value and mobilise unencumbered collateral, including the capabilities to project how unencumbered collateral would change in a stress

Legal review
Since the scope of TWD would include trading activities across all geographical locations, firms with cross-border businesses should engage their Legal Teams fully as a detailed review of ISDAs to model client behaviour / consent would be required to design and adjust packages based on location and potential buyers.

Critical dependencies
While Template B requires information on Financial Market Intermediaries (FMI) costs, firms should also assess potential impacts of adverse actions taken by FMIs, understanding substitutability options, and quantifying the liquidity impact.

Risk management
In addition to estimating RBLs, firms should also have capabilities to identify, quantify and monitor the risks that are most likely to be unhedgeable in stress or wind-down. There should be plans in place to reduce those risks, where possible, prior to loss of market access / liquidity. Firms should also be clear on the risks of counterparties closing out financial contracts in stress or resolution and have in place mechanism to manage these.

Rump analysis
Since there is not a requirement to disclose rump projections in the TWD templates, there is a risk that firms do not pay enough attention to rump positions and end up with a lot of positions they cannot exit within two years. From our experience working with firms through the SWD submissions and our regulatory insight, we know this is one of the focus areas for the regulator. Firms should not only identify and maintain an inventory of potential rump assets and monitor these during wind-down but also forecast costs associated with these rump positions and have an operating model to manage them.

Other areas that are not explicitly stated in SS1/22 but should be considered in our view:

Communications plan

Firms should have communications plans in place that include the parent, home and host authorities, Financial Market Intermediaries (FMIs), key counterparties and any other relevant stakeholders, to ensure there is a clear strategy for disseminating and receiving relevant information in a timely manner.

Booking model

Firms should have:

- An appropriate booking model structure in place that supports recovery and resolution, including an orderly wind-down.
- A comprehensive booking model framework with transparency over what is being booked, where and by whom and with controls in place to manage booking practices.
- Capabilities to ensure robust oversight and management of booking arrangements in line with effective risk management.

Inter-affiliate risks

Firms should also understand, monitor, and manage the risks associated with intra-group trades and guarantees and have the capability to assess how management of these inter-affiliate risks could be impacted by a stress and wind-down.

KEY CHALLENGES FACED BY CLIENTS

Firms are mostly at an early stage in their TWD journey, where some are finalising planning while others are in requirements gathering phase.

Although significant efforts were dedicated to preparing the TWD Thematic Response to the PRA in November 2022, most firms are still struggling to finalise their implementation plans as there is no benchmark provided for what good looks like. This issue is further exacerbated for firms without prior experience of SWD, as TWD guidance is not detailed compared to previous SWD Information Requests, leaving a lot of room for interpretation. In our view, key challenges faced by most of the firms are:

Data management & granularity

Firms do not have a consolidated database with all risk, finance and regulatory reporting datasets in one place. TWD requires a single aggregation tool with datasets at the right granularity (e.g. at least segment / portfolio level) and with the necessary linkages created to be able to assess the impact of wind-down decisions on financial and operational resources.

There are also concerns about the breadth and granularity of data expected in the TWD templates and meeting these capabilities may require entirely new system buildouts, or substantive changes to existing ones.

Large datasets required for TWD, quick refresh requirements and rerunning stress scenarios / sensitivity analysis require a lot of compute power. This is unlikely to be achievable with the existing IT infrastructure.

Dynamic solutions not available

Some banks have performed high-level reviews of trading book wind-down options with the development of high-level segmentation methodologies, this does not satisfy the TWD's expectations where information and tools should be available to segment portfolios in multiple ways in a timely manner.

There is a real need for an automated segmentation / strategy tool which is capable of tagging back book as well as front book, in order to accommodate daily changes in the trading book portfolio.

Sub-optimal solutions in place for existing resolution capabilities

Where the PRA encourages firms to leverage existing resolution capabilities (e.g. FIR, VIR, OCIR) to develop TWD capabilities, most of these solutions are based off tactical solutions and present the following barriers for TWD adoption i) take considerable amount of time (months) to produce results (cannot meet TWD refresh requirements) and ii) exposed granularity is not aligned to what is required for TWD.

Firms with prior experience of SWD also reverted to use of tactical solutions, which are not fit for purpose to meet the TWD target state.

TWD methodologies & assumptions	TWD guidance is not prescriptive enough in certain areas and there is a lack of industry and regulatory consensus, therefore deep technical knowledge is needed e.g. RBLs, KVA, TWD scenario.	Material uncertainties linked to the regulatory framework e.g. Basel 3.1 / FRTB impact on capital projections (AFME letter to the PRA to extend implementation timeline).
Integration into recovery plan	Firms are finding it challenging to see how partial wind-down fits with the recovery options and how TWD capabilities align with recovery planning capabilities.	Firms should be able to demonstrate how plans would be executed and explain any dependencies on third parties in line with expectations around Recovery Planning. This should include demonstrating how the TWD plan sits with recovery and resolution plans, including any relevant trigger frameworks.

PRIORITIES FOR 2023 / 2024

Firms should not view this as another regulatory deliverable but should look to optimise the TWD capabilities and leverage the benefits building these capabilities can bring by i) integrating their TWD capabilities with wider risk management activities ii) building dynamic solutions for TWD; and iii) good quality and granular datasets.

To meet the regulatory expectations of SS1/22, efforts in rest of 2023 and 2024 will be focused heavily on developing and testing TWD capabilities. Particular focus should be placed on:

Governance
Appropriate stakeholder management including engaging all the required SME groups / agree project ownerships

Regulatory interpretation
Finalise methodologies and assumptions on how to calculate various components

PRA Liaison
Regular dialogue with the PRA to demonstrate progress against implementation plan, validate methodologies / assumptions etc.

Resource Management
Complete hiring / engage third party advisors

Scalable systems / capabilities
Develop scalable systems and capabilities upfront rather than relying on tactical solutions

Testing & Assurance
Robust testing and assurance framework to ensure capabilities built are fit of purpose

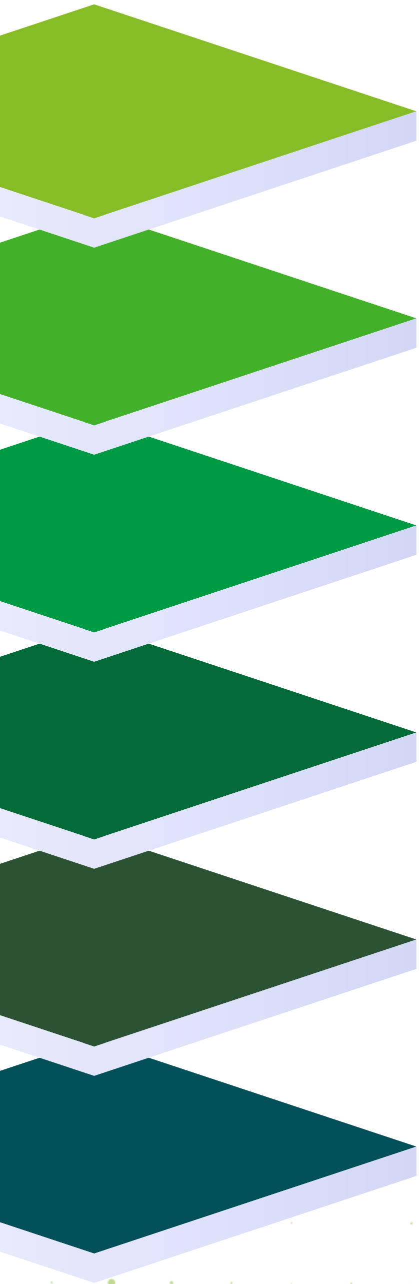
Target Operating Model
Design TWD Target Operating Model clearly identifying BAU ownerships and interactions

Playbooks
Detailed playbooks that set out the relevant actions, governance structures, decision-making processes, communications plans that would be required

Planned Dry Runs
Dedicated dry runs with Board level review and signoff prior to Q1 2025

RRP integration
Integration of TWD in wider risk management activities and into the recovery plan

BENEFITS OF DEVELOPING TWD CAPABILITIES



Single aggregation tool for financial resources

Reconciliation of different data sources (e.g. risk, finance, capital, liquidity, front office, operations) into a centralised database improves the efficiency, versatility, agility and accuracy of the production of regulatory submissions and will improve decision making when seeking to optimise for returns.

Governance

TWD playbooks identify and consolidate governance responsibilities, giving the Board and Senior Management sight of granular activity conducted by trading desks which may not be visible though aggregated MI.

Business profitability

Capital and liquidity requirements and operational costs assessed at the individual portfolio levels can allow management to obtain a more holistic risk/return analysis. Moreover, the identification of ‘rump’ positions provides a granular understanding of risk/return related to ‘sticky’ and challenging positions which might require enhanced attention.

Dynamic segmentation / strategy tool

Ability to run ‘What if’ scenarios for business strategy decisions in addition to regulatory reporting requirements, that will allow back book as well as front book tagging.

Booking models / inter-affiliate risks

Detailed understanding of booking models and risks associated with intra-group trades and guarantees can be leveraged for optimisation initiatives.

Quick data refreshes

Ability to refresh trade level data and associated financial metrics quickly in BAU as well as crisis would enhance risk management and decision-making capabilities (e.g. clarity on RWA, Leverage on T+1 basis).

HOW DELOITTE CAN HELP

Deep Trading Book Wind-Down Expertise
We bring a team of expert resources who have helped international, European and UK banks on developing and implementing wind-down solutions.

Industry Leader in Recovery and Resolution Advisory Services
We specialise in providing strategic regulatory advice including recovery and resolution solutions to institutions both in BAU and distress and can help with alignment between TWD Option and recovery plan.

Extensive Regulatory Insights
We regularly engage with the PRA and the BoE in open dialogue and debate on RRP and Trading Book Wind-Down. Our team of specialists have well over 30 years of combined practical experience and therefore have a deep understanding of the regulatory expectations.

Peer Perspective
We have been advising on Trading / Solvent Wind-Down in capital markets for many years; we can therefore offer real peer insight as well as 'good practice' suggestions collated from previous engagements.

Tried and Tested Transformation Experience
We have established approaches and methodologies to address complex challenges arising from SS1/22 (e.g. the approach to RBLs, KVA, Data Integration and MI) and have the experience to support you on your transformation journey.

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