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The expanding remit of solvent exit and resolution

Challenges and opportunities for smaller banks and building societies

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April 2024

The UK already has a robust resolution regime for banking institutions, which was first implemented in 2009 in the wake of the Global Financial Crisis. The regime centres on the Bank of England's (BoE's) Resolvability Assessment Framework (RAF).

Regulatory focus has historically been on the largest banks. However, attention has now turned to the resolvability and exit strategies of smaller banks and building societies in the UK, with significant implications across multiple areas of their operations.

This paper considers the regulatory proposals, the challenges, and the opportunities facing these smaller firms, and the actions that they can and should be taking to prepare for the new requirements.

The changing landscape of bank failures

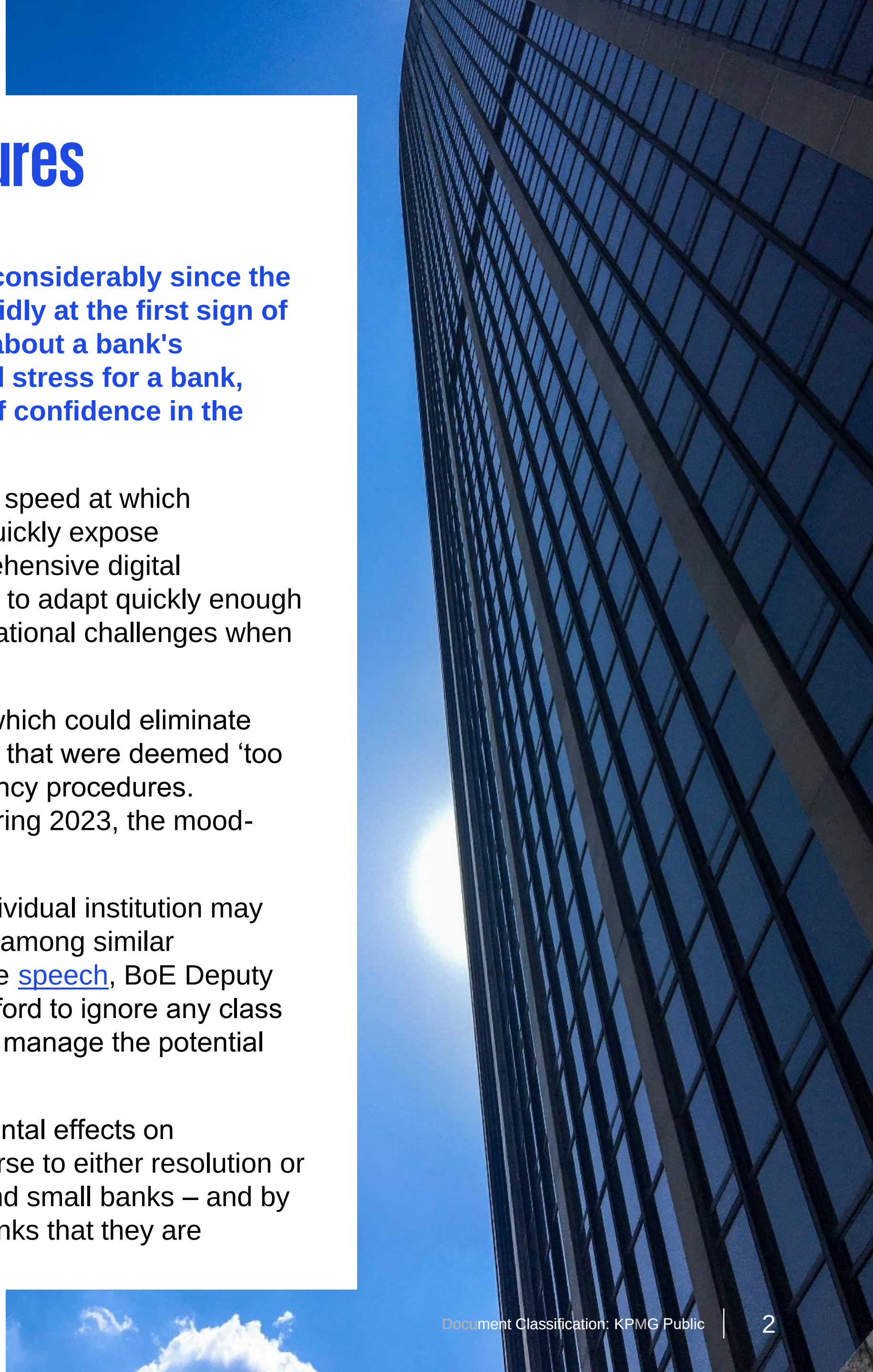
The factors which can contribute to a potential bank failure have evolved considerably since the RAF was established. Customers are now able to withdraw their funds rapidly at the first sign of stress or perceived financial instability, whether these relate to concerns about a bank's solvency, liquidity or overall financial health. This can exacerbate financial stress for a bank, leading to liquidity challenges and potentially triggering a broader crisis of confidence in the banking system.

Perceived vulnerabilities can be amplified by greater digital connectivity and the speed at which information now travels – as seen in 2023, the vast reach of social media can quickly expose weaknesses and accelerate deposit outflows. Where they do not have a comprehensive digital transformation strategy, or have not yet embedded it fully, banks may be unable to adapt quickly enough to changing customer preferences and market dynamics. This may lead to operational challenges when faced with stress situations.

The BoE has always been clear in its intention to avoid a 'zero failure' system, which could eliminate necessary risk-taking from the economy. The RAF was developed for the banks that were deemed 'too big to fail', with their smaller counterparts being covered under standard insolvency procedures. However, following bank failures and the broader period of sector volatility in spring 2023, the mood-music has changed.

In the July 2023 Financial Stability Report, the BoE concluded that, while an individual institution may not be considered systemic, if a risk is common – or perceived to be common – among similar institutions, the collective impact can pose a systemic risk. In his Mansion House speech, BoE Deputy Governor for Prudential Regulation, Sam Woods, noted that the PRA 'cannot afford to ignore any class of bank'. HMT and the UK regulators are therefore now considering how best to manage the potential failure of smaller banks.

The BoE's overarching concern is that banks of all sizes can fail without detrimental effects on customers or the wider financial system. In the past, this ultimately meant recourse to either resolution or insolvency mechanisms. With its renewed focus on solvent exit for both large and small banks – and by placing detailed preparations firmly in BAU – the BoE has signalled a shift to banks that they are expected to take greater responsibility for their own safe exits.



Key regulatory developments

01 PRA PS5/24 (following CP10/23)

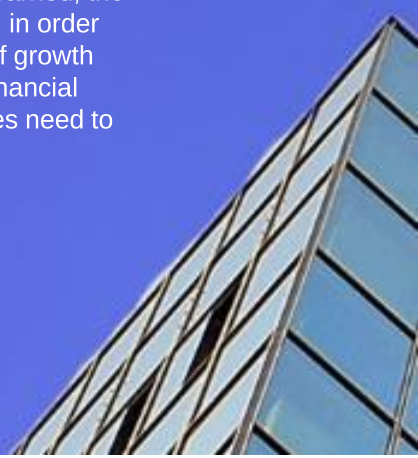
The PRA's policy statement confirms requirements to prepare for and be able to execute an orderly 'solvent exit'. By Q3 2025, all relevant firms, no matter how unlikely the prospect of a solvent exit may seem, must have prepared a solvent exit analysis as part of business as usual (BAU). These firms must also have capabilities in place to draft a detailed solvent exit execution plan, if this becomes a ‘reasonable prospect’. PS5/24 makes consequential changes to SS3/21 ('Non-systemic UK banks: the PRA's approach to new and growing banks'), amending the ‘Solvent wind down’ section. In-scope firms will be subject to a proposed new Chapter 7 of the Recovery Plans Part of the PRA Rulebook.

02 Changes to the legislative framework

In January 2024, HMT proposed that, in certain situations, it may be in the public interest to transfer a failing small bank into a Bridge Bank or to a willing buyer, rather than placing it into insolvency. This would be paid for by a levy on the banking sector, with the cost therefore covered by industry rather than the taxpayer. HMT noted that the proposals would give the BoE increased flexibility without significantly changing the existing resolution regime and would build on – and be consistent with – other work being done to address small-bank resolvability.

03 Updated Purple Book

The BoE has also updated its approach to resolution, commonly known as the Purple Book. Incorporating lessons learned, the book now sets out how, in order to realise the benefits of growth and competition from financial stability, firms of all sizes need to be ‘resolvable’.



Of these developments, the solvent exit proposals set out in PS5/24 are the most tangible starting point for relevant firms.

2022

- 06 — **Jun 2022:** BoE publishes findings from first RAF cycle

2023

- 03 — **Mar 2023:** Failure of SVB
- 06 — **Jun 2023:** CP 10/23 solvent exit planning proposals for non-systemic banks and building societies published
- 07 — **Jul 2023:** Financial stability Report redefining ‘systemic”
- 10 — **Oct 2023:** Mansion House speech
- **Oct 2023:** Second RAF cycle begins

2024

- 01 — **Jan 2024:** HMT consultation on amending legislative frameworks
- 03 — **Mar 2024:** PS5/24 on solvent exit planning for non-systemic banks and building societies published

2025

- 03 — **Mar 2025:** Implementation of solvent exit requirements for large banks
- 07 — **Q3 2025:** Implementation of solvent exit requirements for non-systemic banks and building societies

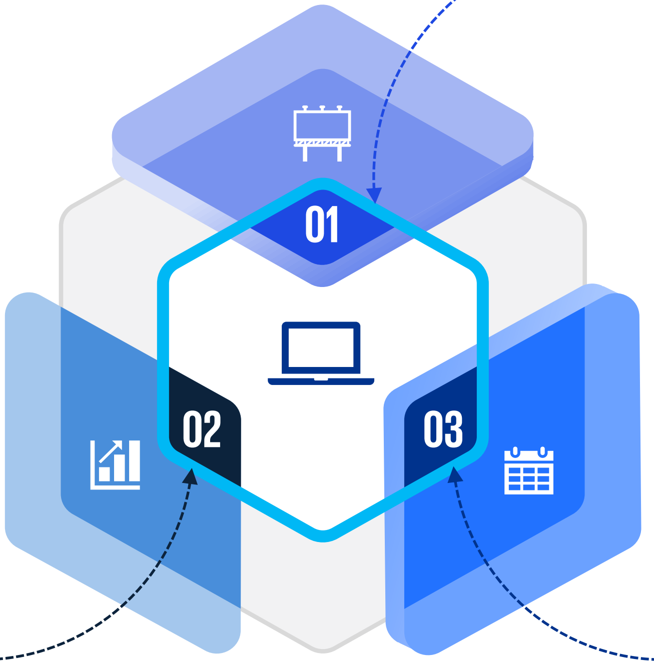
What is solvent exit?

PS 5/24 applies to UK-incorporated banks which are not subject to the Operational Continuity Part of the PRA Rulebook, or not members of a group which is a global systemically important institution (GSII) or an other systemically important institution (O-SII)

Solvent Exit

Facilitates the orderly exit of non-systemic firms from PRA-regulated activities. The process entails:

1. Ceasing PRA-regulated activities, such as deposit-taking, while maintaining solvency.
2. Initiating the repayment of deposits.
3. Concluding upon the full repayment or transfer of all deposits.



Recovery Planning

Aims to establish a framework that ensures financial institutions have robust strategies and mechanisms in place to respond effectively to severe stress scenarios and restore viability.

Modified Resolution

Mitigates the negative impacts of bank failures through implementation of strategies such as:

1. Recovery actions.
2. Resolution measures.
3. Intervention from regulators.

Considerations for firms

With PS5/24 confirming that smaller banks and building societies are expected to meet the requirements of solvent exit planning by October 2025, firms have no time to waste in building out and embedding the necessary capabilities.

These capabilities include developing a solvent exit analysis and solvent exit execution plan – specific details of which can be found in our article here.

Building on this and taking a broader view of how to exit the market, firms should consider the following (based on the BoE's three RAF outcomes):

Adequate financial resources – firms should:

- **Be able to articulate their resolution exit strategy** – breaking down their balance sheet assets/portfolios into sell, transfer, and hold to maturity. There should be a particular emphasis on positions which are difficult to unwind – similar to the concept of a 'rump' in trading wind-down – and a clear understanding of the minimum level of financial resources needed to fund this exit strategy.
- **Understand the funding mix for these required resources** – unlike their larger peers, smaller banks and building societies cannot rely on MREL, as it is more difficult for them to build up the necessary loss-absorbing capital. HMT's proposed changes to the legislative framework would include some funding to be covered by an industry levy. And, moreover, banks in resolution continue to have access to the BoE's published liquidity facilities, subject to meeting the eligibility criteria.
- **Be able to execute Valuation 1 –** (determining whether the bank is failing or likely to fail) **and Valuation 2** (inform use of resolution tools including bail-in), at a minimum, to assess the value of their assets. This should include any adjustments to book values. They may also need to include the concept of PVA for any derivative positions.
- **Ensure that all analysis accounts for any relevant "haircuts"** – i.e. the costs of selling assets or portfolios below book value. They should also consider wider sensitivity analysis, including any factors which could potentially impact the sale of assets (e.g., sale of the deposit book could impact ability to dispose of other remaining assets). Firms should also have an awareness of the scope/profile of potential buyers.
- **Carry out liquidity fire drill exercises** – with particular focus on how a rapid decrease in liquidity can have a corresponding effect on equity and capital. Firms should engage with authorities on how quickly they would be able to receive liquidity support – including prepositioning of collateral and testing preparedness. For more on liquidity fire drills, see our paper here.
- **Consider the impacts of the sale of assets or portfolios** on their wider capital and liquidity profiles.

Considerations for firms (cont.)

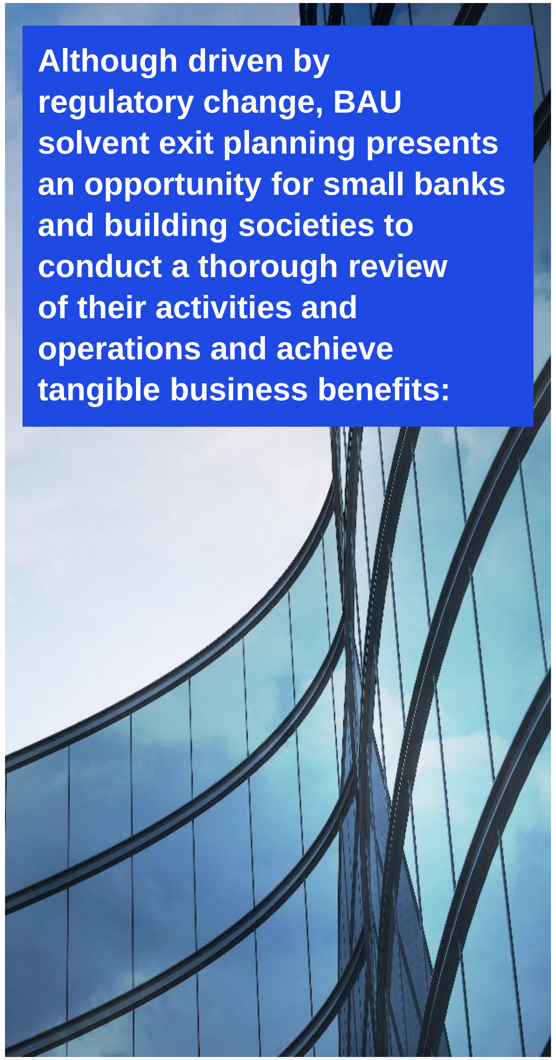
Continuity and restructuring – firms should:

- **Use scenario analysis** in their planning.
- **Consider structural specificities** – restructuring may be more challenging for firms with complex legal and corporate structures (e.g., banks which have taken over other banks including liabilities, or banks with complicated group structures) or firms with longer-term off-balance sheet components (including long-term property leases, contract termination penalties, pension fund contributions and contingent liabilities).
- **Factor in the complexity of arrangements** – e.g., firms using deposit aggregators may face an additional layer of involvement when unwinding assets.
- **Assess the continuity of all operations** – including people analysis and implications on areas such as HR, legal and redundancy arrangements.

Coordination and communication – firms should:

- **Build-out and maintain a full inventory of required documentation** to support solvent exit and/or wider resolution – including all elements defined in PS5/24.
- **Ensure they have a pre-drafted communications strategy** – This can have a critical impact on stakeholder and market confidence, and is especially important in the digital age, where information travels rapidly and across multiple channels.
- **Educate governance committees on the relevant requirements** – in the case of a solvent exit, or wider resolution, directors would need to provide sufficient review and challenge of plans before they can be enacted.
- **Consider the conduct risk impacts of potential restructuring actions** – this could include identifying solutions that provide appropriate outcomes for fixed term deposit holders and agreeing what, when and how to communicate with customers to enable them to make informed decisions.
- **Formalise ongoing assurance protocols** – e.g., solvent exit testing should occur every 3 years and wider fire drills should also be run frequently.

Driving positive outcomes for firms



Although driven by regulatory change, BAU solvent exit planning presents an opportunity for small banks and building societies to conduct a thorough review of their activities and operations and achieve tangible business benefits:

More granular understanding of holdings – assessment of capital and liquidity requirements and operational costs at individual portfolio levels can enable management to develop more holistic risk/return analysis. Moreover, the identification of “rump” positions will provide a granular understanding of risk/return related to “sticky” and challenging positions which might require enhanced attention.

Better risk identification and quantification – the interrogation of underlying planning assumptions – including the review of communication plans, barriers and governance structures – should drive out any main risks to be overcome by firms, creating positive feedback loops that enable them to make more effective strategic business decisions.

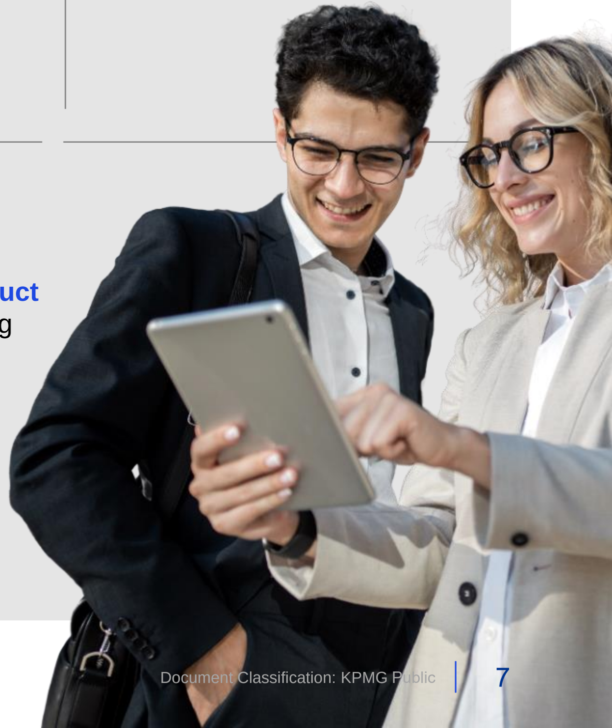
More effective capital deployment – the regular review of assets will facilitate identification of opportunities for balance sheet optimisation and improved profitability.

More accurate and efficient use of data – the reconciliation and streamlining of different data sources (e.g., risk, finance, liquidity, front-office,) and operational processes can lead to additional efficiency gains.

Better external communication strategies – this cannot be underestimated in the digital age and has typically been a historical area of weakness. Communication plans designed for solvent exit or wider resolution could be leveraged in other incidents, e.g., operational disruptions.

Enhanced restructuring capabilities – all of the above will contribute to greater agility in the event of failure and help mitigate the risk of firms being unprepared for a solvent exit or resolution, increasing the likelihood of a successful, less costly exit, and potentially reducing negative impacts on stakeholders.

Consideration of wider conduct risk impacts – holistic planning will lead firms to move beyond prudential considerations and balance their own commercial interests with those of their customers. In turn, this will support compliance with wider FCA initiatives, including the new Consumer Duty.



How KPMG in the UK can help

KPMG in the UK has a multi-disciplinary team that can advise you, not just on the regulatory aspects of solvent exit planning, but also on its commercial, strategic and legal implications. Our risk and regulatory professionals can help you identify business benefits rather than treating solvent exit or resolution as a tick-box regulatory exercise. This, in turn, can help drive process, governance and/or strategic efficiencies.

We have extensive experience of helping banks in this area, including:

- Advising banks on trading book wind-down work
- Development of capital, liquidity and funding projection methodologies
- Sensitivity analysis of key market factors impacting capital and liquidity
- Performing skilled person reviews of solvent exit processes
- Portfolio segmentation
- Testing programme support
- Supporting clients in the preparation and review of solvent wind-down and solvent exit plans, including as part of the authorisation process
- Trading book exit strategy definition.
- Broader recovery and resolution planning
- Identification of operational costs and dependencies

Connect with us to find out more and get updates on future client events.

Contact us:

James Mackenzie

Partner
T: +44 20(0) 7311 5776
E: james.mackenzie@kpmg.co.uk

Shereen Joseph-Becker

Senior Manager
T: +44 (0) 7517 111522
E: shereen.joseph-becker@kpmg.co.uk

Michelle Adcock

Director
E: michelle.adcock@kpmg.co.uk

Bronwyn Allan

Manager
E: bronwyn.allan@kpmg.co.uk

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