BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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Letter sent to Chief Financial Officers of selected deposit-takers

15 April 2019

Dear [insert name]

Written auditor reporting – update and main thematic findings

This letter provides formal feedback to both firms and auditors on the thematic findings from our written auditor reporting work[1], in response to suggestions that this would be helpful. We will also be publishing this letter on the PRA's website.

As you know, we receive your auditors' written response to the questions we ask in the month following the end of the audit; so in April in respect of December year-ends, and in August in respect of March year-ends. We review those reports over the summer and currently feedback our findings to the firms in scope and audit teams within scope over the rest of the year. We also make presentations based on our thematic findings to a range of other parties. With effect from the reporting cycle that is just coming to an end, we intend additionally to set out our thematic findings in a letter to Chief Finance Officers to the firms within scope of the requirements that we will publish for the benefit of others. The letter will not identify any particular firm or auditor.

We have also decided that there is value in including in this letter a summary of the thematic findings from our review of the 2017 (or 2017/2018) year-end written auditor reports that we consider remain relevant. These findings were shared with your auditor in September 2018 when we set out the questions for the 2018 year-end audit. Firm-specific findings have been discussed as part of the regular auditor-supervisor meetings, in trilateral meetings, and in continuous assessment meetings with your senior staff. Those thematic findings are set out briefly in the remainder of this letter and in more detail in the annex to this letter.

Main thematic findings from the PRA's review of written auditor reports received in 2018

The thematic findings summarised below and in the annex all relate to the implementation of the Expected Credit Loss (ECL) approach in IFRS 9. In November 2016 and August 2017, Sam Woods wrote to the CEOs of the larger UK credit institutions to explain how important it is to the PRA that ECL is implemented well and in ways that achieve as much consistency of outcomes as is practicable. My letters to you in 2018 and January 2019 explained the importance we attach to firms providing a comprehensive set of disclosures and presenting those disclosures in a consistent form. Together, those letters set out our expectations regarding the implementation of ECL, including our expectations as to the ECL-related priorities for 2018 and beyond. The letters made it clear that we expect firms' ECL methodologies to evolve for several years after implementation on 1 January 2018, and for the resources and budgets to be made available to enable

[1] Written auditor reporting involves the PRA developing each year a set of questions that external auditors of major UK banks answer in writing at the end of their audit. Our questions give auditors insights into regulatory concerns that may be relevant to their audit work. Auditors' responses help us to make more effective use of the work auditors do in areas that are of interest to supervisors.

that to happen.[2] We repeat our findings below as they set out our view on firms' progress against those expectations.

We recognise that implementing ECL has involved significant effort for firms. I am pleased to see this effort is starting to deliver credit risk management benefits, including more granular and forward-looking credit risk assessments. However, as expected, firms are continuing to enhance their models and evolve the control and governance structures surrounding those models and it is in that context that we set out below the key thematic findings from the PRA's 2018 review:

- A pervasive issue was weaknesses in aspects of firms' controls and management information around new ECL models. We expect firms to continue to enhance their business-as-usual processes around ECL and the upstream data sources.

- The above issue means greater reliance is being placed on governance to identify implausible model outputs and to raise sufficient in-model adjustments and overlays to capture the risks and uncertainties that models had missed. We expect firms to develop and implement plans to better incorporate risks into core ECL models and to address data limitations. (See paragraphs 1 to 6 of the annex.)

- We noted that provision cover was higher where realistic but severe downside scenarios had been considered, and lower where such high-impact, low-probability scenarios were missing from firms' analyses and more weight had been given to base case scenarios. Some firms applied post model overlays (or post model adjustments (PMAs)) to attempt to compensate for gaps in their core models. We are keen to see industry practice evolve in considering the best way to address IFRS 9's requirement to consider multiple economic scenarios and in our view material post model adjustments should be incorporated in core models (See paragraphs 7 to 11 of the annex.)

- We know there will be differences (between firms and across portfolios) in approaches to the key judgement of determining whether a significant increase in credit risk (SICR) has occurred. We are concerned that some approaches will be less responsive to changes in risk when an economic downturn occurs (see paragraphs 12 to 17 of the annex). We saw differences in some firms' approaches to determining the lifetime of an exposure (see paragraphs 18 to 22 of the annex). We are working with firms on various aspects of consistent application of IFRS 9 ECL and expect definitions of SICR and exposure lifetimes to be part of this work. We will also look at the testing firms have done to assess the sensitivity of models to alternative SICR criteria.

If you have any questions concerning this letter, please get in touch with me by email and copy your usual supervisory contact.

Yours sincerely

Victoria Saporta

[2] The letters referred to are available on the Bank's website, see https://www.bankofengland.co.uk/prudential-regulation/letter/2017/transition-disclosures-for-ifrs9-financial-instruments.

Annex
Further details on the key thematic findings from the PRA's 2018 review of written auditor reporting

In this annex we provide a brief description of the supervisory concern behind the question we asked auditors, and further detail on the findings that are summarised in the main body of the letter.

Our aim in providing this feedback is to identify areas where we have thematic concerns. We anticipate that these thematic concerns will also apply to firms not within the scope of written auditor reporting.

As set out in the letter from Sam Woods in November 2016, although it is not our role to set, interpret or enforce accounting standards, we have an interest in how the standards are implemented where the application of those accounting standards has an impact on our statutory objectives (for example, on our assessment of 'fit and proper' or our regulatory capital regime). We continue to consider the effective implementation of Expected Credit Loss (ECL) to be important in ensuring the safety and soundness of PRA-authorised firms so we will continue to work with firms to share concerns, facilitate cross-industry solutions and promote high quality implementation.

Model and data limitations

Supervisory concern

1 ECL estimates may not reflect the key risks associated with firms' portfolios because of limitations in data and models.

2 Firms have had limited time to establish data availability and quality, to calibrate and back test models and to remediate model and data limitations. Model simplifications were used to implement ECL on time and where there were not enough data available to apply a more robust approach. Post-model adjustments (PMAs) are being used to compensate for these limitations as well as to capture 'latent risks' not incorporated in models.

3 Significant levels of PMAs may be consistent with firms not having fully-functioning core models. That raises the risk of bias in provisioning over time if modelling is not improved and the need for: (a) firms to have plans, over time, to reduce the need for PMAs by incorporating risks captured via PMAs into core models; and (b) strong governance around the amount of PMAs and the timing of their release.

Findings

4 A pervasive issue was the weaknesses that exist in aspects of firms' controls and management information around new ECL models. In particular: controls around economic data and forecasts were noted as immature; limited independent testing had been performed to validate models used to calculate ECL; and sensitivity tools to inform oversight of provision adequacy were still being developed to assess the impact of alternative economic assumptions. At the time the reports were being prepared, firms were in the process of fixing data, model and control issues, and putting governance in place. In the questions we have asked for the 2018 (or 2018/2019) year-end reporting, we have asked auditors to share their assessment of the progress made to address data, model and control issues.

5 The reliance on PMAs to address incomplete models or data limitations varies from firm to firm but in some cases is significant. PMAs were used to increase modelled provisions for retail mortgages and, to a lesser extent, credit cards. The more material PMAs used covered items such as refinancing risk, forbearance, affordability, indebtedness, expected lives and economic scenarios. In our 2018 (or 2018/2019) questions, we have asked auditors to share their assessment of the progress made to include these more material PMAs in core models as well as the completeness and adequacy of PMAs in place.

6 One example of where data issues were prevalent was that limited (if any) use was being made of up-to-date external customer level data for provisioning purposes. We saw some evidence that firms are monitoring indicators of a build-up of latent risks related to affordability. However, we remain concerned as to whether risks related to affordability and indebtedness are monitored sufficiently closely and are adequately provisioned. It is important that ECL models make sufficient use of up-to-date external customer level data so they can detect and respond to changes in affordability and indebtedness since underwriting. The indicators we did see being used include: recent reductions in disposable income, customers falling into arrears with increased levels of indebtedness, anticipated interest rate rises and uncertainty arising from the UK's withdrawal from the EU.

Multiple economic scenarios

Supervisory concern

7 ECL estimates may be biased due to the selection of particular economic scenarios (whether optimistic or pessimistic), by the use of out-of-date economic scenarios or by using a number or range of scenarios that is too few or too narrow to capture the full extent of non-linearity.

Findings

8 Different approaches to modelling the impact of economic scenarios have been chosen. Industry practice is evolving around how to capture non-linearity. Approaches that are less robust, may result in provision levels that are biased, particularly if economic uncertainty increases.

9 We noted that provision cover was higher where realistic but severe downside scenarios had been considered, and lower where such high-impact, low-probability scenarios were missing from firms' analyses and more weight had been given to base case scenarios. Firms that had considered just one downside scenario were outliers in considering the effect of multiple economic scenarios.

10 PMAs were used extensively where the output of core models was found to be implausibly low. In particular, PMAs were often used to capture low probability, high impact scenarios. In our 2018 questions we have asked auditors the progress firms have made to enhance models that have been found to produce implausible results.

11 As we have noted above, controls and governance around forecasts were said to be immature with reliance placed on senior committees to apply post model overlays to attempt to compensate for gaps in firms' main models, such as country and portfolio specific shocks. We have asked auditors in our 2018 questions about the progress firms have made to enhance governance.

Significant increase in credit risk

Supervisory concern

12 ECL may be biased due to use of lagging indicators or inaccurate proxy data in the assessments of whether significant increase in credit risk (SICR) has occurred.

13 Approaches might not be appropriately – and from firm to firm, consistently – sensitive to changes in credit risk. A variety of approaches are in use and each has been calibrated in the context of gaps in historic data. These issues contribute to a high level of uncertainty about whether SICR has occurred and how ECL should be measured. As a result, approaches may be biased because there is no established market practice for how to assess the effectiveness of different SICR thresholds.

Findings

14 Most firms use a relative threshold approach for all of their material portfolios. In some of the cases where firms were using different approaches we noted that portfolios had a relatively low proportion

of stage 2 exposures in comparison to peers. We have, in the 2018 questions, asked auditors what evidence they have seen that would support the hypothesis that these two facts are unrelated.

15 A broad range of thresholds for increases in probability of default (PD) are in use. We have asked auditors what potential there is for the use of high PD thresholds to introduce bias into ECL.

16 SICR criteria had been subject to limited validation, with validation metrics to monitor and recalibrate SICR thresholds on an ongoing basis being in development. We have asked auditors their views on the development of metrics used to validate and monitor the calibration of SICR criteria. We also encourage the use of back-testing to assess the effectiveness of SICR thresholds.

17 Some industry standard validation metrics are emerging, for example: the proportion of moves to stage 2 driven solely by back-stop or qualitative criteria; and the proportion of loans that spend little or no time in stage 2 before moving to stage 3. Both these metrics can be used to determine whether SICR thresholds are set too high or underlying PD models are not responding to changes in risk.

Lifetime of an exposure

Supervisory concern

18 ECL estimates may be biased by use of assumptions and policies that determine the lifetime over which ECL is measured or exposure at default. This is particularly true for revolving facilities with retail and corporate customers managed on a collective basis.

19 ECL may be biased by unduly short lifetimes for revolving products where:

- Lives are based on the lender’s cancelation rights, credit review dates if the review is not substantive, or fixed time periods.
- Aggressive interpretations are made that result in de-recognition criteria being frequently met causing existing exposures to be replaced by new exposures even where no substantive change to lending terms has occurred
- Lives or exposure at default are based on inappropriate assumptions about customer behaviour where experience data is missing, including the time it takes for defaults to emerge, how quickly customers will repay or how customers will respond to changes in interest rates.

Findings

20 Approaches to determining lives differed across retail and corporate portfolios and from firm to firm. Lives based on credit review dates were shorter. We have asked auditors whether they consider there is a minimum standard of effectiveness for credit reviews used to determine product lifetimes.

21 The range of modelled lives for credit cards was broad, from three to ten years. We noted that:

- Lives appear to be sensitive to how cumulative default rates are calculated, which seemed to differ between firms.
- Modelled lives were cut short at the point when substantially all defaults occur. Inconsistent use was made of PMAs to capture losses out to the point where all defaults are expected to have occurred.

22 De-recognition criteria differ with more aggressive approaches allowing for de-recognition even where lending terms do not substantively change. We asked auditors how frequently de-recognition criteria are being met in practice to see if this differs across firms.