Bank of England PRA

David Bailey
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30 September 2025

Dear Chief Financial Officer,

Thematic feedback on accounting for IFRS 9 expected credit losses (ECL)

Each year, we receive written reports from auditors of the major UK-headquartered banks and building societies as laid out in Chapter 8 of the Auditors Part of the PRA Rulebook. This letter sets out thematic feedback from our review of auditors' responses.

Our focus for this year, building on our assessment in 2024, remains the importance of recognising changes in credit risk in a timely way in a dynamic and challenging environment, and enhancing capabilities to quantify the impact of climate-related risks (climate risks).

We have seen continuous improvements in firms' capabilities and governance frameworks in these areas. Against that background, the thematic feedback from our review is:

- **Model risk**: Model risk remains elevated amidst the ongoing macroeconomic and geopolitical uncertainty. The current combination of credit risk factors affecting firms' credit portfolios likely differ from those that models were built to capture. It remains crucial that firms challenge the responsiveness of their processes to evolving risks, and the completeness of post model adjustments.
- **Model development:** Firms continue to make progress on multi-year plans to enhance or replace models with longstanding limitations. We reiterate our

encouragement to firms to monitor model redevelopment plans to ensure that investment is targeted at better capturing risk and that end-to-end governance and controls align with supervisory expectations for model risk management.

- **Recovery assumptions:** We continue to see a risk of historical bias in Loss Given Default (LGD) and encourage firms to enhance processes to challenge the realism of recovery assumptions underpinning LGD for potentially vulnerable sectors or borrowers.
- **Climate risks:** We welcome the progress made to improve capabilities to capture climate risks in ECL processes, despite data limitations. We encourage continued efforts to enhance how firms identify, assess and model climate risk drivers that could affect ECL, which align with our existing supervisory expectations. The PRA has consulted on updated supervisory expectations, which we expect firms to take into account once finalised.

Next steps

To help firms benchmark and identify areas for improvement, the annex sets out our narrowed areas of focus for the timely capture of changes in credit risk. For our 2026 analysis, we have asked for auditors' views on firms' progress in these areas. We will also explore the quality of ECL processes around data quality and aggregation, and capturing the effect of securitisation transactions. We encourage you to perform your own assessment against the areas of focus and share that with your auditors.

The findings in this letter do not identify any particular firm or auditor. Supervisors will provide firm-specific feedback to firms and their auditors. We will publish this letter on the PRA section of the Bank's website. If you have any questions concerning the letter, please let me know and copy in your usual supervisory contact.

Yours sincerely

David Bailey
Executive Director, Prudential Policy

Annex

Thematic findings on IFRS 9 ECL

1. This annex covers feedback on model risk, recovery strategies and climate risks from our review of written auditor reports received in 2025, as well as discussions with auditors, firms, and thematic work by PRA staff.

2. We used grey boxes below to highlight those 'areas of focus' where we encourage further progress by firms and which we will continue to monitor through written auditor reports. These areas align with, and build on, existing supervisory expectations.[1,2] The PRA has also recently consulted on proposed clarifications and further details on the supervisory expectations for managing climate risks.[3]

3. Our aim in providing this feedback is to encourage firms to identify improvements that can be made to risk monitoring and measurement, and to the management information used to inform challenge of ECL.

4. The areas of focus have been developed with the size, nature and complexity of firms in scope of written auditor reporting in mind. However, we think that the findings in this letter will generally be helpful to all firms applying IFRS 9 ECL.

5. 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. We regard the effective implementation of ECL, and the timely incorporation of climate risks in accounting valuations, to be important in ensuring the safety and soundness of PRA-authorised firms. We will continue to work with firms to share concerns, facilitate cross-industry solutions, and promote high quality implementation. This includes continuing to engage with firms to examine ways to bring about greater consistency in more subjective elements of ECL, as well as engagement with

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1 May 2023: Supervisory statement (SS) **1/23 – Model risk management principles for banks**.
2 April 2019: **SS3/19 – Enhancing banks' and insurers' approaches to managing the financial risks from climate change**.
3 April 2025: Consultation paper (CP) **10/25 – Enhancing banks' and insurers' approaches to managing climate-related risks – Update to SS3/19**.

members of the UK Finance Disclosure Code[4] Working Group to benchmark climate-related disclosures.

Model risk

6. We remain focused on the completeness of post model adjustments (PMAs[5]) to ensure provisions reflect actual expectations of credit losses.

7. Given the timing of auditor reports, firms were at early stages of assessing risks and uncertainties associated with geopolitical tensions, potential fragmentation of global trade and financial markets, and resulting pressure on sovereign debt markets. We plan to continue to engage with firms and auditors on how these evolving risks are being factored into ECL estimates.

8. We considered the use of PMAs for affordability and end-of-term refinancing risk in light of recent inflation levels and the volume of fixed term loans due to mature in the coming years. We observed these PMAs have generally reduced over time, for example in retail portfolios where the impact of income shocks had materialised on large portions of firms' exposures.

9. Firms had generally maintained their frameworks to identify mortgage borrowers at risk. Better practice we saw for retail exposures included more granular monitoring of the performance of borrowers with higher repayment-to-income ratios, capturing higher vulnerability to increases in repayments.

10. We continue to see scope for firms to expand frameworks for corporates. Better practices we saw included targeted sector-level reviews and more frequent reassessment of corporate loans approaching maturity, to challenge whether processes capture refinance risk on a timely basis.

11. In light of elevated model risk and ongoing uncertainty, the area of focus is:

Robustness of processes to respond to new and evolving risks, and the completeness of PMAs.

12. Firms were at different stages of implementing multi-year strategic plans to enhance models to address longstanding limitations and reduce reliance on PMAs. We saw

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4 July 2017: **UK Finance Code for Financial Reporting Disclosure**.

5 PMAs refer to all model overlays, management overlays, model overrides, or any other adjustments made to model output where risks and uncertainties are not adequately reflected in existing models.

some progress in improving retail model segmentation and aligning to industry practice. However, we generally saw less progress made enhancing corporate models, such as better identifying sub-sector risks and fully integrating forward-looking information into core models.

13. Choice of model segmentation remains important, as using too few segments could mask risks. Firms continued to rely on PMA processes to address sector or segment specific risks not fully captured in models.

14. We saw more firms applying interest rates as a key driver in new retail models, to improve sensitivity to affordability risks. However, practice continues to vary across firms. Given the impact on borrowers from higher interest rates in recent years may not yet have fully emerged, we encourage firms to continue to track the relationship between interest rates and credit losses. Continuing to build this understanding will be crucial to inform future enhancements to modelling capabilities.

15. Firms had generally established governance frameworks to monitor delivery of their strategic plans for model development. Better practice we saw included monitoring the overall impact of model redevelopment by comparing aggregate model performance to a set risk appetite.

16. Given the above, the area of focus is:

Delivery of strategic model redevelopment plans that are focused on better capturing risks and reducing reliance on material PMAs under varying economic and market conditions.

17. Our review highlighted the increased importance of end-to-end controls to ensure the accuracy of data critical to the calculation of ECL. A greater level of new data is being used to build, run and monitor new models. We plan to use the next round of written auditor reporting to explore the quality of governance and processes around source data, data flows and data aggregation. The aim is to better understand current practice around aspects such as: accountability for data risk; completeness and accuracy of critical data elements; data quality management policies and procedures; complexity of aggregation and handling; and oversight of cloud-based

and third-party solutions. This will complement continued supervisory work to assess data accuracy.[6]

18. Given the above, the area of focus is:

> Quality of governance and processes over source data, data flows and data aggregation to ensure accuracy of data that are critical to the ECL calculation.

19. We continue to see differences in the use of model operating boundaries to define the range of economic conditions under which a credit risk model is expected to perform reliably. For example, models trained on a period of benign inflation may not perform reliably during high inflation.

20. Better practice we saw included firms requiring operating boundaries for all new models, with regular monitoring to identify if current and forecast economic conditions fall within these boundaries, and testing model responsiveness to economic inputs outside historical ranges. However, some firms had no equivalent processes or plans to implement them.

21. In line with SS1/23, we continue to regard the use of operating boundaries as important during periods of volatility to help governance committees identify whether models are fit for purpose and challenge completeness of PMAs.

22. Given the above, the area of focus is:

> Monitoring of clearly defined model operating boundaries for new and recalibrated models, based on the range of economic variables used in their development, to help identify performance issues.

23. Enhancing model monitoring and validation remains a priority. Reports noted it will take several years for firms to fully align with the expectations set out in SS1/23 and auditors continue to highlight monitoring limitations and control observations.

24. We saw some firms introduce new models that are capable of more granular, automated and extensive monitoring of model performance. Better practice included monitoring a wider range of different borrower cohorts and ECL components to

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6 January 2025: **Letter from Charlotte Gerken and Laura Wallis 'UK Deposit Takers Supervision: 2025 priorities';** May 2023: **SS1/23 – Model risk management principles for banks**.

enable earlier detection of issues for higher risk cohorts not explicitly segmented in models.

25. However, not all firms had defined monitoring frameworks for new models. We also anticipate gaps in monitoring will exist for newer models trained on more recent data, due to the time needed for loss experience to emerge. Reports noted operational challenges around the quality and relevance of historical loss data and accuracy of code used in automated monitoring. It is important to address monitoring limitations to enhance challenge of model performance.

26. We saw firms had updated their monitoring and validation frameworks in response to SS1/23. For example, extending validation to qualitative and deterministic models, introducing more comprehensive model reviews prior to implementation, and considering the skills and capabilities needed to independently assure judgement-based PMAs.

27. Given the above, the areas of focus are:

- Embedding of more granular monitoring across borrower cohorts and ECL components, on both a pre-PMA and post-PMA basis.
- Implementing and embedding changes needed to monitoring and validation processes to align end-to-end model risk management frameworks with the expectations set out in SS1/23.

Recovery strategies

28. It remains important to challenge whether the recovery assumptions that drive LGD are realistic, particularly for potentially vulnerable sectors or borrowers.

29. We continue to see scope for firms to enhance internal reporting on loans or segments with the highest sensitivity to changes in recovery strategy. Few firms noted sensitivity tools were in place. Better practice included targeted deep dives of vulnerable sectors exposed to downside risk if recovery strategy changed, and closer monitoring of trends for long-term defaults, unresolved, and complex cases. These were used to support use of PMAs and challenge limitations of LGD models.

30. Recovery strategies were generally viewed as stable, relying on model monitoring and individual assessments for corporate loans to detect changes. We continue to see scope to improve the level of review and challenge over LGD models and

metrics, in line with SS1/23. Auditors noted some improvements in LGD model monitoring, with portfolios on new models able to be monitored for more risk cohorts and components of LGD. However, most firms recognised the need to further enhance their monitoring capabilities to address limitations, such as lack of coverage across LGD models, as part of model redevelopment.

31. Given the above, the area of focus is:

> Ensuring early-warning indicators and governance processes are in place to support timely identification of risks of recovery strategies failing for potentially vulnerable sectors or borrowers.

32. Firms and auditors were comfortable that relevant alternative recovery outcomes are sufficiently captured in existing provisions. However, we continue to see scope for firms to enhance their ability to detect and respond to elevated risk of recovery strategy failure in stressed conditions. Examples of recovery strategy failure would include borrowers entering liquidation or receivership, when the preferred strategy is to restructure, or unplanned increases in debt sales.

33. We saw some improvements to make ECL estimates more responsive to borrower- and collateral-specific risks. Better practice included more granular differentiation of borrowers based on their payment behaviour in default, and moving to closer monitoring of work-out trends for unresolved loans in long-term default.

34. Given the above, the area of focus is:

> Continuing to develop more granular LGD models, supported by more diverse sources of recovery data to address lack of data availability, and consider how models can be more responsive to the range of recovery paths borrowers may take.

35. Supervisors have seen a rise in securitisation activity across the industry. Securitisation activity can result in underlying assets remaining on the balance sheet or being replaced by residual exposures. As noted in **a letter the PRA published in April 2025**, the PRA has also observed that some firms provide financing against securitised assets, which can include complex and illiquid collateral. Estimating ECL for positions impacted by securitisation activity can involve complex judgements around the risks retained or transferred, the level of loss protection or the valuation of complex or illiquid underlying collateral.

36. We plan to use the next round of written auditor reporting to explore the quality of processes to capture the effect of securitisation transactions on ECL. The aim is to better understand current practice and risk exposures. This complements ongoing supervisory work on significant risk transfer (SRT) financing, as well as rules and expectations regarding step-in risk, as set out in the Step-in Risk Part of the PRA Rulebook[7] and **SS1/25 – Step-in Risk**, effective from 1 January 2026.

37. Given the above, the area of focus is:

Robustness of processes to capture the effect of securitisation transactions on ECL.

Accounting for climate risks in ECL

38. Our review focused on four capabilities relevant to reflecting the impact of any systemic risk in ECL:

    - identifying the risk drivers most likely to impact ECL;
    - quantitative analysis to challenge the ECL calculation, not just at the individual lending exposure level but also at a portfolio level;
    - adapting economic scenarios and weightings used for ECL calculations to incorporate the risk drivers; and
    - data and models to factor the risk drivers into loan level ECL estimates.

39. Identifying the climate risk drivers most likely to impact ECL continues to rely on firms' expert judgement and understanding of their portfolios, supported by internal stress tests and climate scenario analysis.

40. Risk drivers were generally consistent year-on-year. For retail, firms continue to focus on secured lending and properties vulnerable to physical risks (eg flood, subsidence, coastal erosion, wildfire and storms), as well as the impact of low energy efficiency ratings on collateral values or borrower affordability. For corporate exposures, firms continue to focus on transition risk and the impact of potentially higher carbon prices on borrower profitability.

41. We saw more portfolios being formally assessed for climate risk drivers, though depth and consistency varied. Better practice included:

[7] April 2025: **PRA Rulebook: CRR Firms: Step-in Risk Instrument 2025**.

- granular scenario analysis at sub-portfolio and sub-sector levels to help differentiate risk across business models;
- integrating climate risk into internal stress tests to help consider additive and interacting effects of climate with other economic headwinds; and
- enhancing the use of questionnaires to assess transition readiness in high-risk corporate sectors, including assigning borrowers qualitative risk scores to support closer monitoring.

42. End-of-term refinancing risk did not seem to be consistently considered. Better practice involved identifying borrowers most vulnerable to rising climate-related costs for closer monitoring.

43. We encourage firms to continue to enhance their identification of climate risk drivers that could influence ECL in the following areas of focus:

- Expanding the coverage of sub-portfolios and sub-sectors for which climate risk drivers are assessed.
- Exploring ways to better consider the additive effects of climate with other economic headwinds and how they interact, such as integrating climate into internal stress tests.
- Explicitly considering end-of-term refinancing risk for borrowers likely to face increases in the cost or level of borrowing due to climate risks.

44. Firms continued to make progress in using more granular analyses to assess how specific climate risk drivers affect ECL. No firm identified an immediate material impact.

45. Some firms had begun implementing their first climate-aware ECL models, designed to be more responsive as data quality and climate impacts evolve.

46. We saw progress in modelling both physical and transition risks for retail. Better practice included:

- use of location data to model property damage risk (eg flood, subsidence and erosion) under defined climate scenarios, incorporating collateral and insurance data to estimate ECL; and

- use of energy performance certificate (EPC) ratings and home characteristics to assess borrower affordability and collateral value, factoring in retrofit costs, government policies, household energy costs, and market demand.

47. Coverage remained limited by data gaps, though some firms plan to expand models to cover additional physical risks, such as storm and wildfire.

48. We saw progress to enhance transition risk modelling for corporates. The range of practice included:

    - Borrower-level models to estimate how rising carbon prices and borrowing costs would affect ability to repay under defined climate scenarios. These used borrower-level emissions data and sector-level carbon pricing, and also considered higher credit spreads and debt levels due to increased energy or insurance costs.
    - Sector-level models to estimate credit rating downgrades under different scenarios.
    - Sector-agnostic approaches applying broad scalars to increase provision cover for vulnerable portfolios based on internal stress tests.

49. We saw less progress in physical risk modelling for corporate exposures, where data remain limited. Some firms had begun to assess profitability impacts from property loss or business disruption, and use carbon intensity to assign risk grades to different collateral types for asset finance.

50. Subject to data availability, we see opportunity for firms to make further progress to estimate the impact of climate risks on corporate ECL in the following areas:

    - reducing reliance on simplistic approaches, such as scalars based on moving high-risk accounts to stage 2, or flat haircuts to collateral valuations;
    - considering the implications for significant increase in credit risk (SICR), for example incorporating qualitative climate factors as a backstop;
    - improving links with activities to assess borrowers' transition readiness, and data driven-climate scorecards; and
    - enhancing modelling of physical risks using collateral-specific data.

51. Firms continue to embed the impact of climate risk into business as usual (BAU) credit risk assessments for corporate exposures. Better practice included:

    - embedding climate questionnaires for assessing corporate client vulnerability at loan origination and as part of ongoing review;
    - structured aggregation of questionnaire data to support consistent interpretation, such as assigning qualitative customer risk scores; and
    - introducing policies requiring climate to be considered in downside IFRS 9 cash flow modelling for high-risk sectors.

52. Firms were generally at early stages of developing and testing use of data-driven climate scorecards. While auditors noted scorecards being used to support closer monitoring of vulnerable borrowers, we saw only one firm had used them to produce climate-adjusted ECL estimates.

53. We encourage firms to challenge how climate risks are factored into the ECL calculation, not just at the individual lending exposure level but also at a portfolio level, through the following areas of focus:

    - Increasing focus on more granular sector and portfolio-level assessments that incorporate available borrower and collateral-level data to refine probability of default (PD) and LGD estimates. This will help ensure the analysis is responsive to differing impacts of climate change across different business models.
    - Further embedding the impact of climate risks into BAU credit risk assessments for corporate exposures, including the use of data-driven climate risk scorecards to assess ECL impact.

54. Firms continued to challenge or enhance their economic scenarios to better reflect the impact of climate on ECL.

55. As many credit loss models do not respond directly to climate factors like carbon prices, firms often relied on climate risk being captured in economy-wide indicators, like GDP, which may not reflect firms' specific risk profiles. To address this, we saw firms expand use of dedicated climate scenarios and models to decide if PMAs are needed for specific physical or transition risks.

56. However, some firms made progress in embedding climate risk more explicitly into the design of scenarios used to estimate ECL. The range of practice we saw included adjusting:

    - only the base case scenario by modelling the impact of carbon prices at sector-level and then aggregating these to estimate economy-wide GDP impacts; and
    - only the downside scenario, supported by expansion of internal stress test scenarios to include climate factors such as carbon pricing and sector demands.

57. Alongside enhancing core ECL models to be more responsive to climate factors, we see scope for firms to more comprehensively reflect climate in the scenarios that directly influence ECL in the following areas of focus:

    - Considering a broader range of downside climate scenarios, and climate-related variables, in the economic scenarios used in the ECL calculation; to allow for timely identification of borrowers and sectors more exposed to climate risk than the wider economy.
    - As climate modelling becomes more sophisticated, ensuring scenario expansion capabilities can generate the climate-related variables relevant to the risk profile of the loans being assessed.

58. We saw less progress in the following areas relating to data and models, which we plan to monitor, and which will become increasingly relevant as data quality and availability improve:

    - Identifying the requirements for data and models, and implementing the changes necessary, to factor climate risk drivers into loan level ECL estimates.
    - Enhancing the review and monitoring by second line risk teams of how models and scenarios used to calculate ECL incorporate climate risk drivers.

59. Availability of data remains a pervasive issue that is not unique to ECL. Investment in the necessary data tools and frameworks remains crucial for the development of climate capabilities. This aligns with the PRA's emphasis on data in the consultation in CP10/25.

60. The scope of climate model validation varied, consistent with firms being at early stages of model development. We encourage firms to align their climate model

governance frameworks with the expectations in SS1/23 as they expand their climate modelling capabilities.