Dear [insert name]

**Written auditor reporting – thematic feedback from the 2018/2019 reporting period**

This letter provides formal thematic feedback to both firms and auditors from our review of ‘written auditor reports received in 2019’. We will also be publishing the letter on the PRA’s website.

As you are aware, we received a written report from your auditors responding to our questions on issues of particular supervisory interest. We provide feedback on what we learn from those reports via a number of channels. Firm-specific feedback is then provided to firms and their auditors by supervision through continuous assessment meetings, regular auditor-supervision bilaterals and trilateral meetings to also include the audit committee chair.

We have provided thematic feedback in this letter, which is set out in three parts. The main findings are set out briefly in this letter, with more detail provided in the two annexes to this letter, the first of which covers thematic findings on IFRS 9 Expected Credit Loss accounting (ECL), and the second which covers thematic findings relating to matters other than ECL. The thematic findings do not identify any particular firm or auditor.

**Main thematic findings for the implementation of ECL**

In my letter to you dated 15 April 2019 and in the letters Sam Woods wrote to CEOs in November 2016 and August 2017, we emphasised the importance to the PRA that ECL is implemented well and in ways that achieve as much consistency of outcomes as is practicable. These letters summarised our expectations regarding the implementation of ECL, in particular, they made it clear that we expect firms’ ECL methodologies to evolve for several years after initial implementation at the beginning of 2018 and that we expect the resources and budgets to be made available to enable that to happen.

We are pleased to see that firms are continuing to evolve their ECL methodologies, enhance their models and develop the control and governance structures surrounding those models. It is against that background that we set out below the main thematic findings:

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1 Written auditor reporting involves the PRA developing a set of questions each year 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.


3 The letters referred to are available on the PRA’s website:
• **Controls around new ECL models and data:** A pervasive issue continues to be weaknesses in aspects of firms’ controls and management information around new ECL models. Significant progress has been made in embedding end-to-end controls around economic data and forecasts, but further progress is needed. Auditors also commented on the adequacy of information available to management to enable the effective oversight of complex ECL models. We expect firms to continue to enhance their business-as-usual processes around ECL and upstream data sources.

• **Model adjustments:** The issue above means greater reliance is being placed on governance to identify implausible model outputs and to raise sufficient in-model adjustments, post-core model adjustments and overlays (together referred to hereafter as PMAs) to capture the risks and uncertainties that models missed. We were pleased to hear that in 2018 progress was made in implementing model changes that will reduce the number of PMAs, but we also noted that limited progress has been made in reducing reliance on PMAs to compensate, for example, for low modelled provision cover for mortgages. We expect firms to continue to develop and implement plans to better incorporate risks into core ECL models and to address data limitations.

• **Economic scenarios:** Most firms raised PMAs to attempt to compensate for gaps in how their core models consider multiple economic scenarios. These PMAs captured additional low probability, high impact scenarios related to country or portfolio specific shocks. We are keen to see ECL methodologies evolve in the way which they consider multiple economic scenarios so that core models no longer have these gaps and reliance on material PMAs is reduced.

• **Consistency:** 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, but are concerned that these approaches will not all respond in the same way to changes in risk when economic conditions change. We were pleased to see that some progress has been made in developing metrics to monitor the sensitivity and effectiveness of different SICR approaches, and agree that it is important to have good metrics. However, further progress is needed to ensure metrics are adopted more widely and become industry standard. We are talking to the major UK-headquartered banks and building societies about steps that could be taken to bring greater consistency in the application of IFRS 9 ECL and we expect definitions of SICR to be part of this work.

Whilst we recognise that progress has been made on the above issues this year with significant efforts being made by all the firms, the findings above are consistent with the findings from our review last year in 2018 and the expectations above are unchanged from my letter to you in April 2019.

We have decided it would be helpful to set out our views on practices that would contribute to a high quality and more consistent implementation of ECL. These practices are included in the annexes to this letter and have been developed using our written auditor reporting work, the PRA’s own analysis and discussions with other global regulators. These practices were shared with your auditor in August 2019 and a similar list was shared with your auditor in September 2018.

As part of the next round of written auditor reporting questions for the 2019 year-end audit, we have asked for your auditors’ views on the extent to which your firm has adopted these practices, or has alternative processes in place that achieve the same results. We would greatly appreciate firms engaging with their auditors in carrying out this work by performing their own analysis on how they have adopted the practices and by making that analysis available to their auditors as part of the year-end audit. We intend to discuss wider adoption of these practices with your firm in 2020 as part of our continuing work with firms on consistent application of IFRS 9 ECL.
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
Annex 1
Thematic findings on IFRS 9 Expected Credit Loss accounting (ECL)

Introduction

1. In this annex we set out our thematic findings on ECL arising from the work that we have carried out on the reports we received from the auditors of the banks and building societies (firms) in scope of our written auditors’ reports requirements for the 2018/2019 reporting period (most but not all firms in scope have year ends of 31 December).

2. Our aim in providing this feedback is to identify areas where we have thematic concerns and to encourage firms to identify improvements that can be made to risk monitoring and measurement, and the management information used to inform challenge of ECL estimates. We anticipate that these thematic concerns will also apply to firms using IFRS 9 that are not within the scope of written auditor reporting. High quality practices have been developed bearing in mind the size, nature and complexity of firms in scope.

3. The annex is structured as follows for each area:
   - A brief description of the supervisory concern behind the question we asked auditors.
   - Key findings: These findings include a description of the range of practice we have observed and our view on what would contribute to a high quality and more consistent implementation of ECL. Those practice descriptions are set out in boxes for ease of reference.

4. As Sam Woods explained in his letter of 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 regard the effective implementation of ECL accounting 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. Setting out our view on practices that contribute to a high quality and more consistent implementation of ECL is consistent with our interest in the subject.

Model and data limitations

Supervisory concern

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

6. Firms have had limited time to calibrate and validate models, and to identify and remediate model and data limitations. Model simplifications were used to implement ECL on time and were also used where there was not enough data available to apply a more robust approach. In-model adjustments, post-core model adjustments and overlays (together referred to hereafter as ‘PMAs’) are being used to compensate for model and data limitations.

7. PMAs may be incomplete or inadequate due to: (a) models not being subject to regular, independent validation to ensure the impact of model and data limitations is understood; and/or (b) not raising all PMAs needed to compensate for model and data limitations.

8. Significant levels of PMA may be consistent with firms not yet 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

9 A pervasive issue continues to be weaknesses in aspects of firms’ controls and management information around new ECL models. Significant progress was made in embedding end-to-end controls around economic data and forecasts, but further progress is needed. Limited independent testing has to date been performed to validate models used to calculate ECL. Auditors also commented on the adequacy of information available to management to enable the effective oversight of complex ECL models. We expect firms to continue to enhance their business-as-usual processes around ECL and the upstream data sources.

10 The amount of reliance placed on PMAs to address incomplete models or data limitations varies across firms and portfolios. For example, on mortgages the more material PMAs covered items such as interest-only maturity risk, forbearance, buy-to-let lending, affordability, indebtedness, expected lives and economic scenarios. For some firms a significant proportion of mortgage ECL continues to be the result of PMAs, which is a concern. The range of the proportion of ECL attributable to PMAs was wide, at 0 to 56% (excluding PMAs for economic uncertainty). Some progress has been made during the year to reduce the number of PMAs in place, reflecting the work firms have done to implement model changes and improvements in the availability of data.

11 We saw instances where PMAs being used to compensate for low modelled provision cover on mortgages were apparently calibrated against historic provision levels. Such a practice indicates that the root cause for what would otherwise have apparently been too low a provision was not understood. If the reason for a PMA is not understood, it is difficult to calibrate it properly or know when it should be released. On the other hand, we also saw firms that had introduced policies to ensure the reasons for PMAs were understood from the outset and to address those PMAs in core models within a set period of time (e.g., six months). Such firms typically distinguished between: PMAs that were due to model and data limitations, which the firm could address; and PMAs that were regarded as event driven, which firms expected to see resolved when the event itself passed.

12 Work plans are in place to better incorporate risks into core ECL models and to address data limitations so that reliance on PMAs will be significantly reduced in future.

13 For new PMAs, decisions are taken at the outset on the reasons for the PMA and on how to determine when and how much of the PMA is to be released, and the implementation of those decisions is subject to proper governance.

14 Some monitoring of models was carried out with model risk frameworks being defined to determine the scope and frequency of testing and the Key Performance Indicators (KPIs) against which model performance would be assessed. Findings from model monitoring were generally inconclusive as models had been running for only a short time and in a credit environment generally accepted as being benign, which limited the data available.

15 Regular out-of-sample model testing is used to monitor model performance in accordance with a model risk framework set by an independent function.

16 Sensitivity analysis is used as an integral part of model testing to identify issues that may be hard to spot in current economic conditions.

17 Findings from the model testing are aggregated and reported to key committees in a timely manner.
18 Not all firms carried out independent model validation in 2018. Instead, those firms relied on validation carried out in the run-up to implementation of IFRS 9.

19 In some cases findings were not properly documented, aggregated and shared on a sufficiently timely basis to enable them to be available to inform the challenge of ECL by senior committees.

20 Regular validation of models by an independent function at a frequency based on complexity and materiality but generally not less than annually.

21 Findings are aggregated and reported to key committees in a timely manner.

22 Not all firms maintained a central log of the model simplifications and limitations critical to the ECL calculation and had processes for review and approval of the use of simplifications over time. Some firms used those logs as part of the process for management to challenge the need for additional PMAs.

23 Although model simplifications not captured by PMAs were asserted to be immaterial, we saw limited use of sensitivity analysis to quantify the potential impact of these simplifications, implying that these impact assessments were judgement-based.

24 A log of key model simplifications and limitations is maintained and kept up-to date as part of ongoing model validation.

25 Sensitivity analysis is used to reassess the completeness of PMAs and the risk of bias from ongoing use of model simplifications across a range of economic scenarios.

**Multiple economic scenarios**

**Supervisory concern**

26 Different approaches to modelling the impact of economic scenarios have been chosen. Industry practice is evolving around how to capture non-linearity. 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**

27 Base case scenarios were assigned the highest probability and used as the start point for selecting alternative scenarios. For firms using a small number of economic scenarios, weightings for the base case varied between 30 to 80%.

28 Consensus data was used either to construct or inform the base case scenario. Scenarios were generally refreshed intra-year. Changes in consensus data were monitored in intervening quarters. In some cases, firms applied overrides to the consensus to compensate for lagging data, for example where the firm’s assessment of the downside risk to the economy was more pessimistic than that of the consensus. We saw some firms using economic assumptions that were more optimistic than consensus data but consistent with their strategic plans.

29 The aggregate impact on ECL of differences between base case scenarios and consensus data or market implied forward rates is monitored for indicators of potential bias.

30 Although firms generated a larger number of economic variables than were used to calculate ECL, the processes used to select which variables to include and which to exclude appeared to still be under development. One result of this was that it was
unclear whether the excluded economic variables might have a material impact on loss estimates.

31 The completeness of economic variables used to calculate ECL is reassessed periodically.

32 We saw increasingly that sensitivity tools are being used to assess the impact of alternative economic assumptions and to inform the oversight of provision adequacy. However, the analysis used in 2018 generally focused on the impact of weighting different scenarios at 100% for selected portfolios, with analysis that allows management to focus its challenge on the most impactful economic variables and make informed decisions around those assumptions being limited.

33 If a portfolio’s ECL appears not to be sensitive to the scenarios chosen, it is particularly important to consider whether the economic factors relevant to the progression of credit risk in that portfolio are fully captured in the scenarios used.

34 Sensitivity analysis is used to identify which economic variables or assumptions have the most impact on ECL and to support effective challenge of using reasonably possible, alternative economic inputs. Separate sensitivity analysis is run for different portfolios and jurisdictions.

35 Firms all use different processes to include multiple economic scenarios to capture non-linearity in ECL. Use of multiple economic scenarios increased provisions relative to base case by 8% on average, although the range across portfolios was wide, at between 0 and 40%. Weightings assigned to the more severe downside scenarios also varied, between 2 and 15%. Firms whose core approach is to consider just one downside scenario were outliers in considering the effect of multiple economic scenarios.

36 Most firms used PMAs to capture additional low probability, high impact scenarios related to country or portfolio specific shocks in the 0 to 10% probability range. We saw little evidence of root cause analysis to identify whether the model or data limitations for which these PMAs were compensating.

37 The effect of high impact, low probability scenarios is quantified and used to assess whether the ECL calculation is fully capturing non-linear effects of economic uncertainty.

38 Approaches to capture economic uncertainty are regularly reviewed to identify enhancements that can be made to avoid relying too heavily on PMAs in future.

39 Severe downside scenarios used to calculate ECL were generally described as being ‘aligned’ with stress scenarios used for capital planning. However, we did not see evidence of risk and finance teams working closely together to understand the differences between the ECL calculated for the severe downside scenario used for financial reporting and that calculated in capital planning stress scenarios.

40 Firms used different assumptions to extrapolate economic forecasts beyond the normal forecasting horizon. Mean reversion was generally used, but the period over which the base case and downside scenarios reverted to mean trends varied, with the shortest period for reversion of downside scenarios being 2 to 3 years. In contrast, in some approaches scenarios continue to vary over the full forecast period.

41 Economic and risk departments are involved in selecting the scenarios used to calculate ECL to ensure they are not too narrow and do not revert to the mean unrealistically quickly. In particular, the severity of downside scenarios and the corresponding loss
estimates used to calculate ECL are benchmarked to stress testing with differences justified and documented.

**Significant increase in credit risk**

**Supervisory concern**

42 ECL may be biased due to use of lagging indicators or inaccurate proxy data in the assessments of whether SICR has occurred.

43 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**

44 Most firms use a relative threshold approach based on increases in lifetime probability of default (PD) for all material portfolios. In some of the cases where firms were using a different approach, the portfolios involved had a relatively low proportion of stage 2 exposures in comparison to peers.

45 A broad range of thresholds for increases in PD were used. Thresholds varied across firms, across portfolios and even within portfolios, meaning comparisons were difficult.

46 Most firms acknowledge that quantitative thresholds alone are insufficient to capture SICR and use qualitative indicators to mitigate the risk that loan-level PDs are not differentiating between up-to-date customers.

47 Most - but not all - firms use qualitative indicators for major retail portfolios and those indicators were generally aligned to the ‘high risk’ indicators being monitored at a portfolio level or involved product specific transfer criteria. Those that used qualitative indictors were noted to have a higher proportion of retail exposures in stage 2 than those that did not.

48 All firms use watch lists as qualitative indicators for wholesale portfolios. Issues were raised relating to the use of stale data in watch list processes that resulted in changes in credit risk not being identified on a timely basis.

49 Qualitative SICR indicators are used that align to the ‘high risk’ indicators monitored at a portfolio level by key risk committees. Indicators are tailored to reflect product specific risks; for example, to capture future maturity risk on interest-only accounts.

50 Watch and worry lists used as qualitative indicators are updated frequently, including the underlying data, to ensure that credit downgrades are captured on a timely basis.

51 No firm used separate portfolio-level collective assessments to move pools of higher risk loans to stage 2. We understand this differs from practice seen by some global regulators (and described in IFRS) where collective assessments have been used to reflect sectoral or regional events not fully captured by loan-level assessments.

52 A separate collective assessment is made to assess the impact of emerging risks and events that may not yet be reflected in loan-level PDs. Results are used to determine the need to move pools of higher risk loans to stage 2 and to reassess the completeness of SICR indicators.
We saw increased use of minimum absolute thresholds to prevent exposures moving to stage 2, including use of ‘absolute’ PD thresholds and minimum credit grades. We are concerned that use of minimum absolute thresholds may result in regulatory guidelines relating to use of the ‘low credit risk’ exemption not being adhered to in future unless their use is carefully monitored.

Use of thresholds based on absolute changes in PD or minimum credit risk grades are periodically reassessed to ensure they do not in effect result in application of the ‘low credit risk exemption’ to exposures that are not truly low credit risk.

All firms used proxies to some degree to compensate for missing data, for example due to data missing on transition to IFRS 9. The use of such proxies has generally decreased with time and as firms have made progress in identifying missing data, although some notable instances remain where firms are relying on proxy data for material portfolios without having clear data remediation targets in place.

Data remediation targets are set with the aim of reducing reliance on proxies for missing data to within an agreed – and stated – risk appetite.

Enhanced monitoring of the performance of accounts with missing data is performed to ensure that proxies used remain appropriate over time.

At the time the auditors wrote their reports, SICR approaches had been subject to limited validation and the metrics to be used to monitor SICR approaches were still in development. Wider use of industry standard metrics would be needed to enable meaningful comparisons of the effectiveness of different SICR approaches across firms.

All firms monitored at least some of the following metrics:

- Proportion of moves to stage 2 due to change in PD.
- Proportion of moves to stage 2 due solely to backstop or qualitative criteria.
- Proportion of stage 3 that spent less than 3, 6 or 12 months in stage 2.
- Difference in PD for stage 2 and stage 1.
- Difference in PD for stage 2 and accounts 1 to 29 days past due or on the watch-list.

However, most firms had not set clear thresholds for the metrics they were monitoring that would trigger a review of their SICR approach, because a better understanding of the expected level for the metrics being used was needed before thresholds could be set.

Firms that had put thresholds in place identified issues relating to the timeliness of PDs being updated.

Clear validation criteria and thresholds are set against which the performance of SICR criteria are regularly monitored.

There is a clear escalation process for when thresholds are breached, including a process to determine when and how SICR thresholds should be adjusted.

To ensure consistency within firms, common validation criteria are used where different SICR criteria are used across different portfolios.

Only one firm used sensitivity analysis to identify for closer monitoring the portfolios most impacted by changes in SICR criteria.
Sensitivity analysis is an integral part of ongoing SICR validation to identify portfolios that are to be subject to closer monitoring.

As expected, firms made changes to their SICR approach during the year. While some firms made changes to address findings from independent validation, the rationale for changes was not clear to us in all cases.

Changes made to SICR criteria or thresholds are well supported and the rationale for them transparent.

Recovery strategy

Supervisory concern

ECL estimates for corporate loans may be biased due to use of unrealistic expectations about what recovery strategy will apply to loans in, or expected to, default or how effective that strategy will be.

Findings

Different approaches were used to capture the impact of economic scenarios on recovery rates across defaulted and non-defaulted assets. For non-defaulted assets, firms generally modelled loss given default (LGD) applying the economic scenarios developed for the group, which include a severe downturn in collateral prices. For defaulted assets, it was unclear whether forecasts of borrower cash flows prepared by risk managers consistently incorporated the same scenario elements.

A clear link exists between the economic scenarios and probability weights used to calculate LGD and group economic scenarios used for other components of ECL, in particular consideration of a severe downside scenario.

The use of alternative recovery strategies increased provisions on defaulted loans by 8% on average, with the range across firms and portfolios between 0 to 11%. Provision cover for uncertainty in LGD was higher where firms considered more severe downside scenarios. The impact of applying downside scenarios to selected exposures increased provisions between 11 and 67%.

Tools to monitor the range of recovery outcomes considered in the ECL calculation, and to identify the portfolios most impacted by changes in recovery strategy, appeared to be in development.

Tools are in place to monitor the portfolio-level impact of changing recovery strategy and are used to challenge risk of bias where there is uncertainty over which recovery strategies will apply or how effective those strategies will be under different economic scenarios.

Provisioning for larger corporate assets remains a largely manual process based on case-by-case assessments. While processes had been updated to incorporate the move to forward-looking provisioning, issues were raised around documentation not being in place to support key judgements and insufficient evidence of challenge.

Assessments of alternative recovery strategies were generally performed only for large loans above set thresholds. Extensive use has been made of simplifications for higher volume, lower value loans. These include use of exemptions from considering alternative recovery outcomes and portfolio level scalars.
76 The rationale for different recovery outcomes considered is supported by well evidenced assessments that are clearly documented to allow for timely challenge.

77 Firms generally considered fewer downside scenarios for manual LGD assessments (typically only one downside scenario). Only one firm considered the likelihood of ‘recovery strategy failure’ to ensure non-linearity of LGD was fully captured.

78 The likelihood and impact of ‘recovery strategy failure’ on LGD is considered, by for example considering the possibility of a disposal scenario, as an additional challenge around whether adequate allowance is made for uncertainty.

79 LGD models had been subject to limited testing, with reviews typically being performed for large loans above set thresholds only. The effectiveness and coverage of those model reviews could be improved. Key controls include manual review to determine the need to adjust modelled provisions when accounts are downgraded and moved to more active credit risk management. A pattern of adjustments in one direction may indicate systematic model or data limitations.

80 Effective review and challenge of LGD models is embedded into business-as-usual monitoring.

81 The result of reviews when accounts are downgraded and moved to more active credit risk management are used to identify model and data limitations.

**Lifetime of an exposure**

**Supervisory concern**

82 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.

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

- Lives are based on the lender’s cancellation rights, credit review dates if the review is not substantive, or fixed time periods.
- Aggressive interpretations are made that result in derecognition criteria being frequently met causing existing exposures to be replaced by new exposures even where no substantive change to lending terms has occurred.

84 The impact of lives may be biased if forward-looking PDs are based on subjective assumptions about customer behaviour or historic data that does not cover a full economic cycle or the time it takes for defaults to emerge or customers to fully resolve.

**Findings**

85 Approaches to determining lives for revolving facilities differed across retail and corporate portfolios and across firms. When lives were based on credit review dates, they were shorter.

86 Derecognition criteria differ with some approaches allowing for derecognition even where lending terms appear not substantively changed.

87 The range of modelled lives for credit cards was broad, from three to ten years.

88 Credit reviews used to determine lives are compared against minimum standards of effectiveness to determine whether lives go beyond the next credit review date.
Derecognition policies require evidence that the terms of lending have changed substantially.

All firms estimate lives at a portfolio level, typically by product or country. We saw limited analysis to differentiate between cohorts within portfolios that may have a longer or shorter than average life. For example, the proportion of credit card books that routinely pay the minimum payment each month is generally not differentiated from those that routinely pay the entire balance.

Portfolio segmentation used to determine expected life is periodically reassessed to ensure it is sufficiently granular to capture differences in customer behaviour.

Modelled lives were generally cut short at the point when substantially all defaults are expected to have occurred. Inconsistent use was made of PMAs to capture losses out to the point where all defaults are expected to have occurred.

When lives are modelled based on the point when substantially all defaults are expected to have occurred, the incremental losses to the point where all defaults are expected to occur are considered.

Even though the lives chosen by firms often sat within a range of possible estimates, we saw limited use of sensitivity analysis to monitor: the key drivers of product lives; where the lives firms had chosen sit within a reasonable range of estimates; and the impact of changes to lives within that reasonable range.

We saw differences in PD forecasting across firms that could be explained in theory – but we suspected, not in practice - by different loss experience. For example, modelled lives appeared to be shorter, and their impact on ECL lower, where relatively few defaults were expected to occur after the initial months of entering stage 2. In one case around 90% of lifetime defaults on credit cards were expected to occur within 12 months of entering stage 2, while in another it was expected to take around 10 years for 90% of lifetime defaults to emerge.

In some instances the period of historic data used to support multi-year PD forecasts did not appear to capture an economic downturn (meaning that a significant proportion of loans had neither defaulted nor repaid at the end of the historic period even though they might have done so eventually). It was unclear whether all firms treated these ‘unresolved’ loans consistently; for example whether these were all assumed to repay in full.

The period of historic data used to support forward-looking PDs is monitored to ensure it reflects the economic cycle and the period it takes for accounts to fully resolve. Assumptions about the risk of default on accounts that remain unresolved at the end of that period are regularly reassessed.

Sensitivity analysis is performed and regularly reviewed to monitor the risk of bias from the use of lives that are too short.
Annex 2
Thematic findings relating to matters other than ECL

1 In this annex we set out our thematic findings on matters other than ECL. Our questions to auditors for the 2018/2019 reporting period - most but not all of the banks and building societies (firms) in scope have year ends of 31 December - also covered differences between mark-to-model fair values and transaction prices, balance sheet substantiation and accounting implications of structural reform.

2 Our aim in providing this feedback is to explain areas where we have thematic concerns and to encourage firms to identify improvements that can be made. We anticipate that the thematic findings relating to fair value and balance sheet substantiation will also be relevant to firms not within the scope of written auditor reporting. High quality practices have been developed bearing in mind the size, nature and complexity of firms in scope.

3 The annex is structured as follows for each area:
   - There is first a brief description of the supervisory concern behind the question we asked auditors.
   - The findings are then set out. Those findings include a description of the range of practice we have observed and our view on practices that would improve firms’ reporting. Those practice descriptions are set out in boxes for ease of reference.

Fair value

Supervisory concern

4 Fair values may be misstated due to valuation models not capturing the risk factors they should for portfolios with a history of differences between mark-to-model valuations and transaction or bid prices.

Findings

5 We saw a lack of linkage between the various model risk controls (for example between Day 1 P&L controls, collateral dispute monitoring and model monitoring and validation), with information that may help firms to identify risks not captured in models not being routinely shared or readily available across the relevant functions.

6 Improve the review of differences between mark-to-model fair values and transaction prices to identify the need to raise additional valuation adjustments. In particular, to allow for systematic valuation issues – such as adjustments on capital intensive trades – to be more easily identified.

7 Formalise the linkage between controls over financial instrument valuations to enable better sharing of information and findings across model risk management processes.

Balance sheet substantiation

Supervisory concern

8 Controls over the ownership and validation of ledger accounts and balances may be inadequate to detect cumulative errors until the accounting effect has become material. In particular, where ledger accounts reflect unusual transactions and involve a high degree of manual intervention and posting.
Findings

9 There is evidence that in firms' processes to reconcile and substantiate ledger accounts to corroborative evidence ('balance sheet substantiation') might not be sufficiently robust. Auditors placed limited or no reliance on these processes and instead carried out alternative audit procedures. Auditors told us that the completeness and timeliness of balance sheet reconciliations were being hampered by a lack of clarity over the ownership of accounts. The quality and risk focus of balance sheet reconciliations could improve, including legal entity controls for ring-fencing. Actions to close known control weaknesses were being implemented over long timeframes with firms’ relying on short-term tactical fixes in the meantime.

10 Develop and execute plans to remediate deficiencies in balance sheet substantiation processes, including legal entity controls for ring-fencing, with a focus on closing deficiencies rather than short-term tactical fixes.

11 Monitor and take steps to reduce the number of unsubstantiated accounts and the proportion of reconciliations that fail quality assurance, with a focus on higher risk accounts.

Structural reform

Supervisory concern

12 Accounting implications of transactions undertaken as part of structural reform may not have been fully assessed or appropriately reflected at both group and entity level.

Findings

13 Auditors identified several significant accounting judgements that firms had made to implement structural reform, for example judgements relating to hedge accounting and application of common control accounting principles.

14 Firms have obligations under the Companies Act to manage their financial reporting not only at the Group consolidated level, but also at the legal entity level. We expect groups containing ring-fenced banks (RFBs) to produce audited consolidated accounts at the level of their RFB subgroup parent from year-end 2019 onwards. This heightens the need for a robust control framework and discipline with respect to legal entity accounting and reporting.

15 Closely monitor the substance, materiality and value of intra-group transactions, for example between the service company and the operating firms so that such transactions are not obscured, which would make ensuring compliance with the ring-fencing legislation and rules difficult.

16 Have controls in place to track distributable reserves.

17 Clearly allocate responsibility for financial reporting matters, be it at the centre or entity specific.