BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Chief Risk Officers
[Non-systemic firms]

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Thematic Findings of Internal Audit Review of Collections - non-systemic UK Deposit Takers

Dear Chief Risk Officers

In November 2019 we asked the Internal Audit function ("IA") of a sample of non-systemic banks and building societies to undertake a review of the Collections function to provide assurance to their Boards and to us over the effectiveness of controls in three specific areas of interest:

- Collection processes and control environment;
- Governance and oversight; and
- Regulatory reporting.

This request resulted from the 2019 'Fast Growing Firms' Review'[1] findings, which found untested collections capability and a lack of clarity on how effective plans for scaling up collections activity would be under stress. It also found, in some cases, forbearance practices that were not in line with industry standards and that could mask the level of arrears, delay appropriate recovery actions and thereby impact overall book performance in a downturn.

We selected 42 non-systemic banks and building societies to take part in this exercise, originally to submit the IA report by Friday 31 July 2020. However, due to the Covid-19 pandemic, this deadline was extended to Friday 30 October 2020. The firms in scope represented 42% of non- systemic firms' lending exposures, with 70% of the firms being banks. 54% of the firms in scope had a lending book of less than £2bn; of which 30% was less than £0.5bn.

Half of the IA reviews were conducted by external audit firms. The majority of the firms IA reviews were conducted during the first lockdown period, thus should include a view of controls under stress, with the exception of 9 firms (which were conducted pre Covid-19).

This letter summarises the findings from this review. The main observations are set out briefly in the letter and **Annex 1** contains more details against the specific areas of interest.

[1] FGF review: https://www.bankofengland.co.uk/prudential-regulation/letter/2019/review-and-findings-fast-growing-firms.

Main observations

We are assured from the IA findings that the processes and controls in place for collection operations, from a prudential perspective, are largely adequate and effective across the majority of the firms. However, our observations reinforce the need for some firms to continue to enhance their collections operations; develop the right level of control and governance to ensure its effectiveness, to review the adequacy of resources, to efficiently manage the processes and to ensure adequate oversight at Board level.

The main thematic observations are summarised below:

1) **Overall IA report ratings**

   20% of firms require significant strengthening in the Collections function, with these firms having an overall IA report rating of Amber. No firms had an overall rating of Red.

2) **Nature of IA recommendations**

   Our review of around **225** IA recommendations shows the highest proportion being rated as **Green and Yellow** (i.e. 37% minor, 50% moderate breaches of control procedures). A smaller proportion of recommendations were rated **Amber and Red** (i.e. 12% significant and 1% materially significant control weaknesses) which relate to the following weaknesses:

   a) **Red**: Material control weaknesses relate to issues in regulatory reporting on forborne exposures (the impact of which is likely to have increased given the increase in forbearance volumes since the pandemic) and unsatisfactory execution of collections strategies (including systems, capacity, resource planning and MI).

   b) **Amber**: Significant control weaknesses relate to issues identified as:

      i) Poor prudential policies and process documents;

      ii) Weak Collections control processes; and

      iii) Weak Collections MI and reporting. These controls appear weaker for **SME/Commercial** and **Specialist BTL** lending.

3) **Areas needing improvement**

   We observed the common areas needing improvement to be:

   a) **Collection processes and control environment**:

      i) Policy and process documentation;

      ii) Controls over collections activities, in particular oversight of operational controls and establish or improve Quality Assurance frameworks;

      iii) Collections capacity planning and training, in particular ensuring contingency resource skills are suited to collection activities and the capacity plans accurately reflect Covid-19 solutions; and

      iv) Alignment to regulatory reporting requirement, in particular definitions and rules, mainly for the definition of default and unlikely to pay indicators.

   b) **Governance and oversight:**

i) Collections MI (including third party MI) mainly on forbearance metrics and trends; and

ii) A significant number of Boards appeared to be generally **unsighted on levels of forbearance**.

c) **Regulatory reporting:**

i) The majority of firms were compliant with regulatory reporting requirements with a few exceptions, mostly on forbearance; and

ii) As noted in the 2021 UKDT Supervisory Priorities letter[2]; the submission of complete, timely and accurate regulatory returns continues to be the foundation of effective supervision, and as such the PRA expects all firms to continue to take action, as necessary, to ensure the integrity of regulatory returns.

In order to allow firms to consider their own collection operations, further details of the main thematic observations across all firms, are set out in **Annex 1**. Please note that no individual firm information is identifiable from any thematic feedback provided to all firms.

Next steps - Action for all firms

We are aware that collection controls and processes are under review for many firms, in particular in light of the increase in collections activity due to the Covid-19 pandemic. We hope you will find the content of this letter a helpful reference when considering your own collection operations and potential areas that might need strengthening.

Please note that we will continue to monitor firms' Collections functions in light of the Covid-19 pandemic impact on arrears and forbearance levels.

Yours sincerely

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[2] UKDT Supervisory 2021 Priorities: https://www.bankofengland.co.uk/prudential-regulation/letter/2020/ukdt-supervision-2021-priorities.

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Annex 1 – Detailed observations from our thematic review of Internal Audit reviews of Collections

Our approach

We analysed the Internal Audit (IA) reports and mapped the recommendations according to the defined areas in scope of this exercise.

We used a four colour rating scale to map all the findings from each report. Where the firm's IA report was based on three colour scale, we have used our judgement to achieve a consistent set of outcomes.

Rating	Features
Red	Key control is not in place Key control is not designed to mitigate the intended risk Evidence that the key control is consistently not operating as intended Non-compliance with key procedures/standards
Amber	Aspects of the risk management and internal control framework require significant strengthening Processes are not identifying key risks as required or on a sufficiently timely basis One or more key risks are not being fully managed, and controls over certain risks are poorly designed and/or are not operating effectively There is significant room for improvement in management's approach to risk and control.
Yellow	Control failures identified, but not in key controls Evidence that a key control has failed occasionally, but compensating controls mitigate the risk impact Non-compliance with procedures/standards (but not resulting in a key control failure)
Green	Minor breach with procedures/standards Control operating but not necessarily efficiently or in accordance with best practice

Overall observations

In respect of the three areas in scope and the total number of IA recommendations:

1) **Collection processes and control environment** represented **77%** of the total number of recommendations (mostly rated yellow);
2) **Governance and oversight** (including the adequacy of the **Management Information** "MI") represented 18%, although the majority of the firms recognised the need to improve Collection MI;
3) **Regulatory reporting** represented 3%, the majority of the firms are compliant with regulatory reporting requirements in line with FINREP and EBA, with a few exceptions;
4) The remaining **2%** related to other recommendations outside of our three areas of scope.

The table below summarises our observations based on firms' Internal Audit recommendations.

Scope Area	Observations
COLLECTIONS PROCESS & CONTROL ENVIRONMENT ***1. Review and assess the effectiveness (from a prudential perspective) of the end to end processes and controls in place that support the Collections activities***	Firms' IA were requested to cover three specific topics as follows (the percentages represent the number of recommendations in proportion of each area): **a) Appropriateness of prudential policies and procedures:** i) **63%** relate to weakness in the policy/process **documentation.** Examples include (but not limited to): lack of version control, process descriptions, up-to-date terms of

a) Appropriateness of prudential policies and procedures in relation to Collections effectiveness; *b) Effectiveness of controls of end to end Collection operations (including any third party involvement in the Collections and arrears process);* *c) Adequacy of current resources, and of contingency resourcing plans in the event of a material increase in customers experiencing financial difficulty and/or missing payments;*	reference, consistent terminologies, annual review and delegated authority. ii) **20%** relate to ensuring **alignment to regulatory reporting requirements** in terms of definitions and rules (i.e. FINREP, EBA Non Performing Exposure (NPE), Unlikely to pay ("UTP"), default). iii) **7%** relate to inconsistent **internal definitions.** Examples include (but not limited to): type of forbearance, what constitutes a group of connected counterparties, watchlist inclusion and alignment to existing Risk Appetite. iv) **7%** relate to **policy** and the omission of details on the management of vulnerable customers, fraudulent cases and legal procedures. v) **3%** relate to the requirement to update **policy** with Covid-19 FCA payment deferrals guidance. **b) Effectiveness of controls of end to end Collections operation:** i) **42%** relate to weak **controls over Collection** activities and weak monitoring or oversight from an **operational** point of view, such as: identification of arrears or default trigger points, early signs of financial difficulty, oversight and monitoring processes. ii) **14%** relate to weak or absent **quality assurance** frameworks (including risk based sampling of cases). iii) **12%** relate to poor **forecast or forward looking analysis** (in line with the ICAAP) of expected default exposures to predict impact on Collections resources. iv) **11%** relate to the remediation of system issues or system migration or lack of validation control checks. v) **10%** relate to weak data control processes for **regulatory reporting.** vi) **9%** relate to improving communications with customers in arrears. vii) **Only 3% relate to improvement of IFRS9 analysis to include the impact of forbearance and arrears** (in particular where the ECL model is based on limited collection and forbearance experience). **c) Adequacy of the current resources, and of contingency resourcing plans in the event of a material increase in customers experiencing financial difficulty:** i) **66%** relate to **enhancing resource capacity plan** and **training** (e.g. to ensure that the contingency resources skillsets are aligned to the Collection activities or that the capacity plan accurately reflects the Covid19 response and solution). ii) **16%** relate to strengthening of **management of third party Collection** (in terms of monitoring performance, quality

	assurance, training, formalisation of policies and procedures). iii) **13%** relate to enhancement of **documentation or monitoring of the Collections capacity plan** (examples include: formalisation of processes, mitigating actions, individual skills; alignments between documents). iv) **5%** relate to taking action to avoid or mitigate, potential staff conflict of interest, when moving resources across teams in support of the Collections activities.
GOVERNANCE AND OVERSIGHT ***2. Review and assess the adequacy of the prudential MI provided for Collections*** *a) Sufficiently detailed prudential MI on Collections is reported to relevant governance committees at different levels within the organisation.* *b) This results in robust and timely decision making, in particular for arrears and forbearance.* ***Firms were requested to submit their Board/Board RiskCo Collections MI as reviewed in 2) above.***	**Firms' IA were requested to cover two aspects (the percentages represent the number of recommendations in proportion of each area):** a) **68%** relate to **improve or enhance Collections MI**. Examples include (but not limited to): inclusion of arrears by stock and flow, inclusion of forbearance MI, Risk Appetite setting on arrears metrics, inclusion of complaints data, actions logs, inclusion of IFRS9 data). b) **11%** relate to fixing data or systems limitations and performing reconciliations between different data sources. c) **9%** relate to moving away from manual processes and increasing levels of automation. d) **9%** relate to improving controls on MI and production of reports, end to end processes and documentation (incl. third party MI). e) **3%** relate to enhancing record keeping of arrears or data sources used to produce MI. **The PRA reviewed firms' MI reported firstly at Board Level and secondly at other Risk Committees and observed the following:** **Board level:** a) **70%** of the firms reported arrears metrics to the **Board/Executive Committee**, however only **45%** included Forbearance metrics, of which only **3%** included Covid19 payment deferral metrics (this may be due to the timing of the reviews). b) **25%** of firms' MI **did not report any Forbearance MI** to the Board/Executive Committee. 30% is unknown as the MI was not submitted with IA report. A significant number of **Boards appear to be generally unsighted on levels of forbearance.** **Risk Committee:** c) **73%** of the firms reported arrears metrics at **Risk Committee** level, however only **55%** included Forbearance MI.

REGULATORY REPORTING ***3. Review and assess the processes and controls in place supporting the reporting of forbearance arrangements that do not accrue arrears.*** *a) Identification of any Collections or forbearance arrangements where missed payments are not reported and arrears do not accrue on accounts* *b) Confirm that any Collections or forbearance arrangements that do not accrue arrears (as identified above) are correctly reported under firm's accounting policies and in regulatory capital returns*	Firms' IA were requested to confirm that any Collections or forbearance arrangements that do not accrue arrears are **correctly reported** under firm's accounting policies and in **regulatory capital returns**. In the majority of the cases, **arrears always accrue** for all firms with the exception of: a) **6 firms**: identified some inconsistency in the way **forbearance arrangements** are reported (example include: understatement of forborne exposures into regulatory returns, reporting errors or misalignment between internal and external regulatory reporting); b) **2 firms**: identified minor inconsistencies between what is disclosed in the ICAAP and in the regulatory reporting;