BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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29 September 2021

Dear Chief Financial Officer

## Thematic feedback from the 2020/2021 round of written auditor reporting

This letter provides thematic feedback to both firms and auditors from our review of written auditor reports received in 2021 and further discussions with firms, auditors, and other global regulators.

Each year, we receive 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 through a number of channels. The main thematic findings are briefly set out in this letter, with detail provided in the two annexes. The first annex covers thematic findings on IFRS 9 expected credit loss accounting (ECL). The second annex covers thematic findings relating to the global benchmark reform. This letter also sets out how we intend to use next year's round of written auditor reports to explore risks related to climate change.

The findings in this letter do not identify any particular firm or auditor. Supervisors provide firm-specific feedback to firms and their auditors through continuous assessment meetings, regular auditor–supervisor bilateral meetings, and trilateral meetings involving supervisors, your auditors, and your audit committee chair.

## Thematic findings on IFRS 9 expected credit losses

Our work in 2021 focused on progress made by firms to embed high-quality practices and lessons learned from how firms have responded to Covid-19 challenges.

Our previous letters have explained the importance the PRA attaches to ECL being implemented well and in ways that achieve as much consistency of outcomes as is practicable. We have also 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[1]. My letter of 2

[1] November 2016: 'Implementation of IFRS 9 Financial Instruments'; August 2017: 'IFRS 9 Financial Instruments'.

October 2019[2] put forward a direction for some of those changes by setting out our views on practices that would contribute to a high quality and more consistent implementation of ECL ('high quality practices'), and so reduce the risk that firms will recognise inappropriate levels of provisions. We envisaged that some of the high quality practices would be in place by the end of 2020, but we also recognised that, given the lead time needed for change, others would take more time.

To monitor progress, we asked for your auditor's views on the extent to which your firm has applied the high quality practices during 2020. We also asked auditors how firms strengthened their ECL processes to respond to Covid-19 challenges.

We recognise the challenges firms faced in implementing ECL, given the very high levels of uncertainty around Covid-19. We were pleased to hear about the significant efforts made by all firms to adapt ECL processes for Covid-19. However, we also heard about the disruption to firms' ability to make lasting changes to ECL approaches. While we were encouraged to see progress in key areas, our findings regarding the further progress needed to embed high quality practices are broadly similar to prior year. We also think it will be important for firms to consider how temporary changes made to strengthen ECL processes in stress can be made more permanent, to help firms be better prepared for future stresses.

It is against that background that we set out below the main thematic findings:

## Model risk

- Model performance deteriorated in 2020. This was in part due to unprecedented levels of government support, which distorted recent credit data, but it was also due to limitations in firms' approaches, including lack of granularity in reflecting sector specific risks. Firms' model risk controls operated with an inherent lag and varying degrees of disruption, and in general failed to identify the full scale of model performance issues. Firms have had to rely on post-core model adjustments (PMAs[3]) informed by ad hoc processes and data that sit outside of their core controls. This placed increased pressure on scarce credit risk modelling resource and management's ability to oversee complex models effectively. We continue to expect firms to consider the adequacy of their resourcing and infrastructure for monitoring model performance, and to react to weaknesses identified, including regarding the adequacy of management information that enables effective oversight of models and PMAs. In particular, it will be important for firms to set strategic

2 October 2019: 'Written auditor reporting – thematic feedback from the 2018/2019 reporting period'.
3 The term PMAs refers to all of in-model adjustments, post-core model adjustments, and overlays, to capture the risks and uncertainties that models missed.

plans for longer-term model redevelopment, and to formalise the frameworks used for assessing sectoral risks and for integrating relevant data from the pandemic into models.

- We continue to consider it crucial that firms make appropriate use of PMAs based on expert judgement, to ensure that provisions reflect actual credit risk expectations, and that those PMAs are the subject of high-quality governance. PMAs increased modelled ECL by around 21% on a weighted average basis at June 2021. We saw firms making limited progress at putting in place frameworks to ensure Covid-19 related PMAs are not released before the underlying issues leading to implausibly low modelled provision cover are addressed. We saw limited root-cause analysis performed to distinguish temporary data issues from longer-term limitations in how models capture risk. We understand that model changes will take time to develop and need more real data on which models can be trained. However, PMAs are only a temporary solution. We continue to expect firms to give due priority to the need to reduce reliance on PMAs when determining their strategic plans for longer-term model redevelopment.

## Economic scenarios

- We saw firms and auditors increasing their use of peer benchmarking and sensitivity analyses to inform challenge around the use of alternative economic assumptions. While Covid-19 has demonstrated the importance of such capabilities in stress, a continuing limitation of firms' ECL processes remains the significant time and manual effort needed to perform sensitivity analysis. We continue to regard it as essential that firms develop capabilities to perform more comprehensive economic sensitivity analysis more quickly to inform robust governance and support comparable public disclosures. To make progress, firms need to define the capabilities they need and set realistic timelines for implementing them.

- Firms and auditors had limited access to timely, granular, and comparable data to support peer benchmarking, in particular around severe downside scenarios. We continue to support efforts by firms to enhance public disclosures, including through engagement with the recommendations of the Taskforce on Disclosures about Expected Credit Losses.[4] We also encourage firms to work together and with us to identify new ways to improve access to peer benchmarking data in times of uncertainty.

[4] December 2019: 'Taskforce on Disclosures about Expected Credit Losses (DECL) updated guidance'.

### Recovery strategies

- We saw firms making less progress in adopting high quality practices relating to recovery strategies used in estimating loss given default (LGD) than in other areas of ECL. We also saw limited use of adjustments to LGD to reflect the elevated risk that past experience may not necessarily be a good predictor of future recovery rates, for example due to forbearance and uncertainty over recovery strategies and rates for customers in vulnerable sectors. It will be important for firms to monitor the impact of the unwinding of government support in order to make realistic assumptions about recovery strategies for vulnerable sectors.

## Next steps on IFRS 9

Next steps are summarised below, with supporting detail provided in the first annex to this letter.

- **Embedding high quality practice:** We think the challenges created by Covid-19 give the high quality practices described in my October 2019 letter even greater significance. For that reason, the PRA's expectations regarding the adoption of high quality practices are unchanged from that letter. To help firms identify improvements they can make, we have set out our views on the most significant gaps between practices observed by the auditors at the time they reported back to us, and the high quality practices shared with you in 2019. Except for recovery strategies, which we reviewed for the first time, these gaps are similar to those we identified in the prior year.

- **Lessons learned from Covid-19:** We identified eight new areas brought to light by Covid-19, where we think further mitigating actions are needed to ensure that firms recognise changes in credit risk in a timely way. These areas mainly relate to model risk management and capturing sectoral risks, where we see benefit from further higher quality and more consistent practices being developed in the light of lessons learned from Covid-19. As part of next year's round of written auditor reporting, we have asked for your auditors' views on the robustness of your processes in these areas. We encourage you to engage with your auditors in carrying out this work, by performing your own analysis and by making that analysis available to your auditors as part of the year-end audit.

- **Consistency:** We welcome the progress that firms have made in developing recommendations to bring about greater consistency, starting with multiple economic scenarios in early 2022. We hope these recommendations will support further adoption of high quality practices and help identify new ways to improve access to peer benchmarking data in stress. I look forward to discussing those recommendations and your firm's plans to make such changes to the ECL approach as are necessary to bring about greater consistency in 2022 and beyond.

## Benchmark reform

While liquidity is decisively shifting towards robust alternative Risk-Free Rates, transition remains a significant operational and financial risk. In the context of written auditor reporting, we remind firms of the importance of managing and controlling the financial reporting aspects of the transition. To encourage firms to identify practical improvements that can be made in financial reporting, the second annex sets out our views on the most significant gaps between practices that auditors observed when they reported back to us, as compared to the high quality practices shared with you in 2020.

## Climate change

We intend to use next year's round of written auditor reporting to explore risks related to climate change. The PRA's Supervisory Statement (SS) 3/19[5] sets out that climate change, and society's response to it, present financial risks that are relevant to the PRA's objectives.

In the context of financial reporting, our supervisory concern is that firms may not fully capture the impact of climate-related risks on balance sheet valuations. We understand that – while the effects of climate change risk on financial statements are getting more attention – auditors did not identify specific risks of material misstatement related to climate change for your recent financial reporting. The proper identification of risks of material misstatement is important to bank supervisors, as it impacts the extent of audit work performed that supervisors can make use of in reviewing firms' own risk assessments.

As part of next year's round of written auditor reporting, we have asked for your auditor's views on how robust your firm's risk assessments are regarding the impact of climate change on balance sheets, and the quality of the underlying data, models, and processes to support these assessments.

We will be publishing this letter on the PRA's website. If you have any questions concerning it, please get in touch with me by email and copy your usual supervisory contact.

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5 April 2019: SS3/19 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change'.

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Yours sincerely

Victoria Saporta

Executive Director, Prudential Policy, Prudential Regulation Authority

## Annex 1
## Thematic findings on IFRS 9 expected credit loss accounting (ECL)

1. In this annex we set out our thematic findings on ECL from our review of written auditor reports received in 2021. Those thematic findings cover the most significant gaps between practices observed by the auditors at the time they reported back to us, and the high quality practices described in my October 2019 letter. We have also added observations to set those findings in the context of Covid-19 and lessons learned from how firms have responded to Covid-19 challenges. In particular, we identified eight new areas where we think further mitigating actions are needed to ensure that firms recognise changes in credit risk in a timely way. These areas are emphasised for ease of reference and were developed based on further discussions with firms and other global regulators. 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 estimates.

2. The high quality practices set out in the October 2019 letter were developed with the size, nature, and complexity of firms in scope of written auditor reporting particularly in mind. However, we think that the findings in this letter will also be helpful for firms applying IFRS 9 that are not within the scope of written auditor reporting.

3. As Sam Woods explained in his letters published on 25 November 2016 and 7 August 2017, 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 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.

### Model risk
#### Progress embedding high quality practices in 2020

4. Focus on model risk management increased in 2020. We saw new governance put in place to increase challenge of model outputs by a wider set of senior stakeholders. Firms' control frameworks operated with varying degrees of disruption. We saw some firms delay independent model reviews to focus on calculating PMAs. We also saw numerous instances of control deficiencies, indicating stretch in key modelling teams.

5. In spite of these challenges, firms made some progress in enhancing model risk management. We also saw auditors increase their use of reperformance and recoding

procedures to increase the likelihood of detecting where models are not responding to changes in risk. However, we judged firms to have partially adopted the high quality practices.

6. The most significant gaps we identified are similar to last year and were:

- The scope of model testing and validation performed did not cover all material models and critical data used to calculate ECL, including new models and critical data introduced to calculate material Covid-19 PMAs.

- The performance data used in model monitoring were skewed towards the performance of models under benign conditions. As more recent loss experience becomes available to compare models against, we continue to see opportunities for firms to perform more frequent and detailed model back-testing across a broader set of models. In particular, we see scope for firms to enhance their approaches by back-testing ECL both pre- and post-PMAs to increase the likelihood of model limitations being identified.

- We see scope for improvement in how findings from model testing and validation are aggregated and reported to enable management to assess the overall direction and significance of model limitations.

- While firms seemed to accept that certain model simplifications have not held up in the current environment, limited use was made of sensitivity analysis as part of model risk management in order to challenge risk of bias from ongoing use of model simplifications. We see opportunities for firms to enhance both the documentation of model simplifications and the analytical tools used to challenge the completeness of PMAs.

### Observations in the context of Covid-19

7. We continue to consider it critical for firms to make use of PMAs to ensure that provisions reflect actual credit risk expectations, and that those PMAs are the subject of high-quality governance. Models were not calibrated to deal with such a short, sharp economic shock, and recent credit data had been distorted by government and other support.

8. The nature and use of PMAs have changed dramatically during the pandemic:

- As at June 2020, PMAs reduced modelled ECL by around 9%[6] on a weighted average basis; the range across firms varies from a reduction of over 30% to an increase of 73%. The most material PMAs were to suppress the modelled impact of a negative economic outlook to reflect the expected impact of government-led support measures on projected losses.

- As at June 2021, PMAs increased modelled ECL by around 21% on a weighted average basis; the range across firms varies from an increase of 7% to 78%. The most material PMAs were to suppress the modelled impact of an improved economic outlook to reflect the impact of past government-led support on current arrears rates and credit utilisation.

9. We saw firms making limited progress at putting in place frameworks to ensure Covid-19 related PMAs are not released before the underlying issues are addressed. We understand that some PMAs will unwind mechanically as credit metrics normalise, and that firms will need to continue to use judgement to react to emerging issues. However, we saw limited root-cause analysis performed, which would help firms to understand the different factors contributing to implausibly low modelled provision cover. This would help to distinguish temporary data issues from longer-term limitations in how models capture risk. To ensure PMAs are not released too soon, it will be important to identify the extent to which PMAs compensate for recurring risks and ongoing model limitations.

10. We understand that model changes will take time to develop and need more real data on which models can be trained. However, we continue to expect firms to give due priority to the need to reduce reliance on PMAs when determining their strategic plans for longer-term model redevelopment.

### Areas that would benefit from higher quality and more consistent practices being developed in light of Covid-19

11. The areas emphasised below set out five areas relating to model risk management where we think further mitigating actions are needed to ensure that firms recognise changes in credit risk in a timely way.

12. As model performance deteriorated, there was increased demand for information to understand the limitations in firms' models and data, as well as how PMAs were being used to compensate for these limitations. Covid-19 exposed common operational issues relating to models, and limitations in the analytical tools that deliver the information

[6] Calculations include all firms in scope of Written Auditor Reporting.

needed to support effective model oversight in stress. Examples of this include the time and effort it takes to calculate ECL and run sensitivity analysis, the complexity of models and reliance on manual intervention, and lack of alignment of model segmentation with business needs. Firms appear to be in the early stages of setting plans to address the changes they need to make to recalibrate models, remediate model limitations, and to deliver the longer-term modelling capabilities and the analytical tools needed to support effective model oversight in stress. The PRA will be conducting UK retail model review work in Q4 2021, and as part of that work will ask participating firms to discuss their strategic plans.

**13. Setting strategic plans for longer-term model redevelopment, recalibration, and validation, and considering the sufficiency of resourcing in modelling teams to deliver those plans.**

14. Robust governance around use of pandemic data will be essential. The unprecedented scale of government support has distorted the recent credit data on which credit ratings and scores are based, for example by suppressing arrears and credit utilisation. If recent data is incorporated too mechanically into models, then those models may under-predict defaults if similar government support is not available in future. Similarly, models may under predict defaults if they are calibrated on data skewed towards credit performance under relatively benign conditions.

15. We saw some firms delay planned model recalibration to prevent recent data having an impact on model performance. However, this created a backlog of work to update models built with data that are several years old. We also saw limited evidence of banks having clear processes to determine the most relevant historical data with which to calibrate models over time. This is not a new issue. Similar issues arose relating to forbearance in previous crises. For that reason, we think it is important that firms develop strategies and processes that can be applied consistently over time.

**16. Developing clear strategies and processes for integrating data from periods of stress into models that can be applied consistently over time.**

17. Lack of segmentation in models and data to reflect sector specific risks was a common limitation in firms' ECL methodologies throughout the pandemic. Many models were not calibrated to differentiate vulnerable sectors. To compensate, firms used ad hoc processes when performing more intensive sector level reviews aimed at assessing provision cover for vulnerable sectors.

18. Sectoral analysis tended to be manually intensive and varied in scope and depth across firms. Practices we saw included combinations of the following:

- Top-down analysis to identify concentrations of exposure to corporate sectors most at risk and inform adjustments to risk ratings for all exposures in specific sectors.

- Bottom-up analysis to independently review a sample of individual exposures within higher risk sectors to inform adjustments to individual credit ratings, which were extrapolated across other similar exposures in the same sector.

- Enhancing annual credit file reviews to require assessments of individual borrowers' ability to manage the crisis and sustain any extra-debt taken on during Covid-19.

19. Auditor reports reinforced the importance of data and analytical tools being available to enable granular sector analysis to be performed. We think capabilities to do sectoral analysis quickly and accurately will play an important role, not just to navigate a path through Covid-19, but for future emerging risks such as climate change and energy price volatility.

**20. Building capabilities to do more granular sector level analysis, and establishing formal frameworks to assess vulnerable sectors and high risk retail cohorts in times of stress.**

21. Firms had to rely on PMAs informed by a high volume of ad hoc data and models that sit outside their normal processes and controls, such as independent validation. We saw limited evidence of firms having plans in place to enable them to scale-up or adapt controls at the onset of stress. This put increased pressure on scarce credit risk modelling resource. Some ad hoc data and models were subject to hastily adapted controls, and some firms delayed performing key model controls to free resource to focus on PMAs. This put increased pressure on governance to assess and challenge the integrity of adjustments.

**22. Embedding more agile and robust control frameworks that can adapt to the need to increase the use of ad hoc data in stress, including the scope of validation for models and data used to calculate PMAs.**

23. While model monitoring identified some deterioration in model performance in 2020, model monitoring did not identify the full scale of model performance issues relating to

Covid-19. This was in part due to the inherent lag in controls such as back-testing. Management increasingly relied on judgement to identify implausible model outputs and to raise sufficient PMAs to compensate.

24. We see opportunities for firms to strengthen model monitoring tools by developing early warning metrics that could signal changes in model performance and help inform the use of PMAs. Covid-19 increased awareness of the operational limits of models. However, we saw only one example of a firm undertaking analysis to assess which models were most likely to have passed 'breaking point'. This analysis involved comparing the scenarios used to calculate ECL to the range of scenarios used in model calibration, as well as comparing model outputs against historical loss rates.

25. **Defining operating boundaries for models and putting in place metrics to identify when those boundaries are likely to have been breached, in order to help inform more focused use of PMAs.**

## Economic scenarios

### Progress embedding high quality practices in 2020

26. Firms' approaches to selecting economic scenarios were largely unchanged in 2020. We saw some improvements in firms' processes that allowed them to better capture economic uncertainty, such as the use of additional and more severe downside scenarios and greater use of peer benchmarking data to challenge economic assumptions. However, we judged firms to have partially adopted the high quality practices relating to economic scenarios. The most significant gaps we identified are similar to last year and were as follows:

- We continue to encourage all firms to develop the capability to perform more comprehensive economic sensitivity analysis more quickly. A continuing limitation in firms' approaches is the considerable time and effort it takes to evaluate the impact of both alternative economic scenarios and individual variables (eg unemployment). To make progress, firms need to clearly define the capabilities they need and set realistic timelines to implement them. We also see scope for firms to set policies to embed greater use of sensitivity analyses to support robust governance and more comparable public disclosures.

- We continue to encourage firms to increase the level of rigour around use of benchmarking data to monitor for indicators of potential bias. While firms typically benchmarked the severity of their downside scenarios to stress tests, and their base case scenarios to consensus data or market-implied forward rates, differences tended still not to be aggregated or monitored in terms of the impact on ECL. While scenarios reflect management expectations, benchmarking revealing a lack of directional consistency may call into question whether expectations are reasonable and supportable. It is important to consider not just the severity of the scenarios chosen, but also the appropriateness of the effect on ECL. Because differences tended not to be monitored in terms of ECL, it was not always apparent whether firms were aware of how material these differences were.

- While Covid-19 increased firms' awareness of the limitations in their chosen approaches to selecting alternative economic scenarios, we saw limited evidence of steps being taken to review how economic uncertainty is captured for the purpose of identifying enhancements that can be made to approaches that reduce reliance on PMAs over time.

- We saw a lack of internal challenge around whether the downside scenarios used to calculate ECL are sufficiently severe to fully capture the non-linear effects of economic uncertainty. Prior to 2020, we saw firms consider 'low probability, high impact' scenarios in the 0% to 10% probability range. In 2020, we saw some firms consider more likely scenarios, while other firms considered more severe scenarios. It was not clear to us that both approaches were equally effective at capturing non-linearity.

### Observations in the context of Covid-19

27. Firms continue to consider multiple economic scenarios differently. While it is hard to make direct comparisons, the ECL impact of multiple economic scenarios continues to vary across firms. Based on PRA calculations, as at June 2021, overall the use of multiple economic scenarios increased reported ECL relative to the base case by 11% on a simple average, but the range across firms varies from 0% to 41%. Applying 100% weight to the most severe downside scenario would have increased reported ECL by 68% on a simple average, with the range across firms varying from 3% to 251%. The probability weights assigned to the most severe downside scenario varies across firms from 2% to 30%. Similarly to last year, we maintain that where both the severity of scenario and probability weightings differ across firms, it is unclear whether firms have common definitions for what their base case and severe downside scenarios represent.

28. As noted above, we continue to encourage firms to improve both the rigour of their use of benchmarking data and sensitivity analysis. We found firms and auditors had limited access to timely, granular, and comparable data to support peer benchmarking, in particular around severe downside scenarios and probability weights. However, we also note that early in the pandemic there was no effective consensus around base case economic outlook. While Covid-19 was an extreme event, it was also the first time that ECL has been tested.

29. We welcome the progress made by firms to come up with recommendations to bring about greater consistency regarding how multiple economic scenarios are considered. As part of that work, we encourage firms to work together, and with us, to identify new ways to improve access to peer benchmarking data in times of uncertainty, and to identify how that data can be used as part of the control framework around multiple economic scenarios.

## Areas that would benefit from higher quality and more consistent practices being developed in light of Covid-19

30. The text emphasised below sets out an area relating to multiple economic scenarios where we think further mitigating actions are needed to ensure that firms capture the full extent of non-linearity.

31. Firms all use different approaches to select probability weights. Some approaches focus on the likelihood of a given scenario occurring and rely on changes in a specific economic variable (eg GDP), while others focus on the likelihood of a given loss occurring and rely on comparison to historical loss rates. Covid-19 has led firms to reassess the limitations in their chosen approaches. For example, they may question whether they consider too few variables, or whether experience from past recessions is representative of current expectations. Some firms made relatively late changes to assign higher probability weights to downside scenarios. It was not apparent to us that these changes were supported by robust quantitative analysis.

32. Given the above, we see scope for all firms to consider a broader range of analysis (eg considering more or different variables) to substantiate their selection of probability weights.

**33. Robustness of quantitative analysis used to inform judgements relating to probability weights.**

## Recovery strategies

### Progress embedding high quality practices in 2019 and 2020

34. Our last review of firms' practices relating to recovery strategies was performed in early 2019. We saw firms making some progress on documenting the rationale for different recovery outcomes to allow for timely challenge and to embed greater review and challenge of LGD assumptions. Overall, we saw firms making less progress in adopting high quality practice than in other areas of ECL that we have more actively monitored. The relative lack of sophistication in LGD models for ECL is consistent with few firms having approval for internal ratings based LGD models for regulatory capital purposes. The most significant gaps identified were as follows:

- Firms lack tools to monitor the ECL impact of changing recovery strategy at a portfolio-level, including for more vulnerable sectors where there is uncertainty over which recovery strategies will apply or how effective those strategies will be in the current environment.

- Few firms consider the likelihood and impact of recovery strategy failure when performing LGD assessments; they could, for example, consider the possibility of a disposal scenario to challenge whether adequate allowance is made for uncertainty. Alternative recovery strategies were typically only considered for large exposures and at the point their preferred strategy failed. Only one firm explicitly incorporated the likelihood of recovery strategy failure by including it as a specific downside scenario in their manual LGD assessments, which we regard as good practice.

- Our concern is that without the tools and processes above being in place, changes or failure in recovery strategy will be reflected in ECL with a lag and only after they occur.

- We saw weaknesses in processes to support a clear link between economic scenarios and probability weights used to calculate LGD and those used for other components of ECL. For defaulted assets, we saw a lack of checks to ensure consistency between the forecasts of borrower cash flows determined by risk managers on a case-by-case basis, and group economic scenarios.

- Extensive use of simplification has been made to incorporate economic scenarios and weightings into LGD models. Simplifications were typically supported by the assumption that LGD should not be particularly sensitive to the economic cycle. However, we saw limited efforts to challenge the completeness of economic variables factored into LGD estimates.

- We saw limitations in the level of review and challenge of LGD models. In particular, we saw a lack of reviews when accounts are downgraded and moved to more active management to identify model and data limitations.

### Observations in the context of Covid-19

35. We saw some key credit risk processes not being performed as planned, suggesting resource stretch in recovery teams. Examples of this include updates to collateral values and annual credit file reviews being delayed. While in part these delays reflect temporary issues related to Covid-19, such as access to properties during lockdown, such delays increase the risk of provisions being based on stale data unless backlogs are addressed.

36. We saw examples of some firms engaging in good practice by using analysis of the level of defaults expected under different scenarios to consider the likelihood of collections resource being sufficient to execute recovery plans. We think such analysis can be useful both to plan resource and inform realistic ECL estimates. We encourage all firms to proactively monitor the adequacy of their collections resource under a range of scenarios.

### Areas that would benefit from higher quality and more consistent practices being developed in light of Covid-19

37. The text emphasised below sets out two areas relating to recovery strategies where we think further mitigating actions are needed to ensure that firms use realistic expectations about what recovery strategy will apply to loans, and how effective that strategy will prove.

38. We saw limited adjustments made to modelled LGDs to reflect elevated risk that past experience may not necessarily be a good predictor of future recovery rates. As a result, most firms’ recovery rates mainly reflect their loss experience in benign years, given that limited default and recovery data have emerged since Covid-19 began.

39. Some firms used PMAs to address recovery rate uncertainty. The more material PMAs we saw include: applying additional collateral haircuts for corporate customers in higher risk sectors, uplifting LGD to align to levels observed in previous recessions, and extending recovery times for retail exposures in response to uncertainty over the impact of repossession moratoria. Only one firm was noted to have adjusted LGD to reflect

increased likelihood that customers will be offered forbearance following removal of government support.

40. As more loss data becomes available, it will be important for firms to monitor the impact that the unwinding of government-led support schemes are having on repossession times and recovery rates, in order to make realistic assumptions about recovery rates.

**41. Considering whether the historical recovery experience used to calculate LGD is consistent with the firm's forward strategy for working with customers, in order to inform challenge of LGD.**

42. Modelled LGDs are not calibrated to fully differentiate recovery strategies for customers in vulnerable sectors. Assessments of alternative recovery strategies have tended to be performed only for large loans above set size thresholds. Those thresholds are not intended to reflect the riskiness of the sector the customer is in. To compensate, we saw some firms enhance processes to consider a wider range of recovery paths for more vulnerable sub-sectors, including possible debt sales.

**43. Considering whether and how recovery strategies and rates for higher risk sectors are likely to differ.**

## Significant increase in credit risk (SICR)

### Progress embedding high quality practices in 2020

44. Firms made some progress in embedding SICR monitoring activities and controls. However, we judged firms to have partially adopted the high quality practices relating to SICR. The most significant gaps we identified are similar to those identified last year and were as follows:

- Industry standard validation metrics are yet to emerge, with differences across firms in the metrics being considered part of their routine model monitoring, as well as the principles used to construct those metrics. We continue to believe that wider use of industry standard metrics are a good first step towards benchmarking the effectiveness of different approaches across firms in recognising SICR in a timely manner. In addition, further progress is needed to embed clear monitoring thresholds based on a sound understanding of the expected level for the metrics being used.

- Not all firms used qualitative SICR indicators to capture risks not otherwise captured in loan-level probability of default (PD). In wholesale, some firms include all loans on watchlists in stage 2, while outlier firms include a proportion of loans on watchlists in stage 1. In retail, better practice included leveraging existing customer behavioural data (for example, change in income, debt to income, deposit data, employment status) to identify 'high risk' indicators, including over-indebtedness and negative affordability, and to monitor at a portfolio level. Other qualitative indicators considered for retail loans include: forbearance, use of payday loans, and interest-only-loans approaching maturity without a confirmed repayment vehicle.

- Further progress is needed to embed business-as-usual approaches for use of collective assessments, to challenge the need to move pools of higher risk loans to stage 2 in order to reflect the impact of emerging risks and sectoral or regional conditions. Examples of emerging risks include climate change and sovereign downgrades.

### Observations in the context of Covid-19

45. While we saw some firms change their SICR criteria to be more consistent with their peers, a wide range of SICR approaches and thresholds continue to be in use. As at 30 June 2021, the proportion of loans in stage 2 varied across firms, from 1% to 12% of retail mortgages; from 7% to 31% of credit card balances; and from 9% to 31% of corporate loans.

46. Some of these differences will be because of differences in the books involved, and because of differences in assumptions made about future economic conditions. However, we remain concerned that the use of a wide range of SICR approaches and thresholds may mean approaches do not all respond in a sufficiently similar way to changes in risk as economic conditions change. We intend to discuss adoption of more consistent SICR practices with firms in 2022 as part of our continuing work with firms on consistent application of IFRS 9 ECL.

### Areas that would benefit from higher quality and more consistent practices being developed in light of Covid-19

47. We have reviewed our high quality practices for SICR in light of Covid-19 and no changes or additions were deemed necessary.

## Annex 2
## Thematic findings relating to benchmark reform

1. In this annex we set out our thematic findings on benchmark reform. Our aim in providing this feedback is to explain thematic observations and to encourage firms to identify improvements that can be made. We anticipate that the thematic findings will also be relevant to firms not within the scope of written auditor reporting.

2. The annex is structured as follows. There is first a brief description of the supervisory concern behind the question we asked auditors. The findings are then set out. The findings are set in the context of the high quality practices in my letter of 30 September 2020[7] and are focused on financial reporting. They support the PRA's broader supervisory recommendations and milestones set out in the letter of March 2021.[8]

### Global benchmark reform
#### Supervisory concern

3. Firms may not fully identify, understand, and actively manage the risks associated with the cessation of panel bank Libor benchmarks (with the exception of the 1-day, 1-month, 3-month, 6-month, and 1-year USD Libor settings, which will continue, for use in legacy contracts only) at end-2021. This includes having processes in place to support an orderly transition from Libor[9] to robust alternative reference rates (including risk-free rates (RFRs[10])) ahead of end-2021. This could have implications for financial reporting and, as a consequence, regulatory capital.

#### Findings

4. While progress on transition was made during 2020, momentum in building RFR liquidity has seen significant acceleration during 2021. This meant the impact of benchmark reform on the audits of financial statements in 2020 was limited. We anticipate that greater focus will be necessary for the 2021 financial statements. We were pleased to see that firms mostly incorporated the high quality practices identified in the 2020 letter on written auditor reporting. However, we noted room for further improvement against those practices. The most significant gaps we identified were as follows:

- Firms appear to have established robust governance structures and embedded granular transition plans. However, we see opportunities for more active management of

7 30 September 2020: 'Thematic feedback from the 2019/2020 round of written auditor reporting'.
8 March 2021: 'Transition from LIBOR to Risk Free Rates'.
9 The focus is on the transition to alternative reference rates driven by the reform, globally, of major interest rate benchmarks. References to Libor should be read to include other interest rate benchmarks that are expected to be discontinued at or after the end of 2021 as part of global benchmark reform, including EONIA.
10 In this document, reference to RFRs encompasses RFRs and other robust alternative reference rates.

transition risks, and for ensuring plans to mitigate those risks are kept up-to-date. This includes regular challenge of aspects of transition that have not been addressed in sufficient detail in firms' plans. We encourage firms to continue to plan for unforeseen circumstances and, where possible, to have fall-back strategies in place.

- We see opportunities for greater use of independent review and challenge of RFR transitioning plans. In the better reports, we saw examples of internal auditors identifying granular gaps in transition plans. However, we saw no evidence of internal audit involvement in reviewing RFR transition programmes for effectiveness for some firms.

- Similar to last year, some firms were still making extensive use of manual processes to capture and aggregate IBOR exposures for internal reporting and external financial reporting disclosures. Noting the short time remaining, we reiterate the benefits of automated systems being in place to support aggregate reporting of IBOR exposures, and to ensure there is a single, standardised, and accurate view of both conversion progress to date and the scale of conversion activity remaining. Where further automation is not practical, it is important that reliance on manual processes be governed by formalised and documented controls over data extraction, validation, and aggregation.