Bank of England

Please note: This letter has been prepared for the website. Square brackets show where this letter may differ slightly, along with formatting from those versions sent directly to firms.

Prudential Regulation Authority

Chief Risk Officers
[**All PRA Asset Finance lenders**]

David Bailey
Executive Director
Melanie Beaman
Director
UK Deposit Takers Supervision

7 November 2022

[Dear Chief Risk Officer]

Asset finance sector – key themes and control weaknesses identified post-administration, in relation to the Arena Holdings Group of companies

Background

Earlier this year following the failure and administration of the Arena Holdings Group of companies ('Arena'),[1] the Prudential Regulation Authority (PRA) asked a number of banks to provide us with their lessons learnt from this event.

The large number of UK lenders with connections to the failed Arena Holdings Group, and the total exposure across all the lenders being disproportionate to the size of Arena, raised questions around the robustness of banks' credit risk management frameworks[2] and controls in the asset finance sector.

The PRA therefore conducted a cross-firm review of the findings from banks' lessons learnt exercises in order to identify key themes and areas of weakness with respect to credit risk and control environments. We are sharing our observations to help banks

---

[1] The Arena Holdings Group comprised of a number of legal entities including Arena Television Ltd and Arena Aviation Ltd which were active in the outside broadcast and aerial filming industry with c.28% UK market share. For details on the Arena event, please refer to the report published by the Administrators, under filing history dated June 2022: **ARENA HOLDINGS LIMITED insolvency**.

[2] PRA Fundamental Rules. Available at: **https://www.prarulebook.co.uk/rulebook/Content/Part/211136/25-10-2022**.

that are active in this sector to consider improvements and enhancements to strengthen their credit risk management frameworks.

Areas needing improvement

Based on the banks' findings, we have listed below our key observations of the areas that were highlighted as requiring improvement:

a) risk appetite and underwriting;
b) asset inspections and supplier vetting;
c) in-life account management and roles and responsibilities;
d) automated transaction monitoring and data capabilities; and
e) industry engagement and fraud controls framework.

The detailed findings and actions being taken by banks are provided in the **Annex**; and we recognise there is some overlap between these.

The key control weaknesses we identified are:

1. **Risk appetite in relation to Single Name Concentration (SNC) risk**

   Most banks' risk appetite limits on SNC or customer level limits were inappropriately calibrated in this instance. With more appropriate risk appetite limits, most of the banks could have reduced the extent of losses. Risk appetite limits should be considered in the context of any high volume and low value assets being financed.

2. **Asset Inspections (AI)**

   The level of inspection and verification of assets (as security for loans) was undertaken by banks to varying degrees and was generally found to be inadequate. This was exacerbated by the assets being in use on locations at the time of inspections, Arena's pushback, and access limitations arising from the Covid-19 pandemic. Individual banks have now taken steps to improve their AI processes. Banks should review and enhance their AI policies and processes to mitigate the risk of a similar event.

3. **Supplier vetting**

   In this situation, the main supplier of assets for Arena was a small sole trader with a disproportionate number of asset transactions and was also not an authorised dealer of the Original Equipment Manufacturers (OEMs). This was identified as a major weakness by most banks. Significant improvements in supplier vetting have either been introduced already or are in the process of being implemented. Banks should review and enhance their supplier vetting policies and processes to mitigate the risk of a similar event.

4. Industry initiative on the creation of an asset register

Banks identified an absence of industry-wide information for asset finance lending, for example a common shared register like the Hire Purchase register, which makes it harder to avoid systemic risk. We encourage banks to continue to engage on an industry-wide basis regarding the creation of an asset register which would help to ensure authenticity of assets as securities and protect from duplicate or false references in asset-based lending.

Next steps

a) **Banks with a connection to Arena** – we will continue to monitor banks' lending functions in light of the lessons learnt from this event and expect banks to periodically update their supervision teams on the progress made on the implementation of their action plans.

b) **Banks with no connection to Arena** – the content of this letter is intended as a reference point when considering your own asset finance lending control frameworks and operations in terms of potential areas that might need strengthening.

Yours sincerely

David Bailey	Melanie Beaman
Executive Director	**Director**
UK Deposit Takers Supervision,	**UK Deposit Takers Supervision,**
Prudential Regulation Authority	**Prudential Regulation Authority**

Bank of England

Prudential Regulation Authority

Annex – Detailed observations from our review of lessons learnt across banks in relation to the Arena Holdings Group

The table below summarises detailed findings based on 19 banks' reports.

Detailed findings in reports	Key actions being taken by banks
a) Risk appetite and underwriting	
a) Most of the banks had inappropriately calibrated their risk appetite limits on Single Name Concentration (SNC) or customer level limits. Risk appetite limits and triggers should be calibrated in the context of any high volume and low value assets being financed. b) Banks were unable to identify the extent to which other lenders had provided credit facilities (sometimes on the same asset). Banks recognised that this could have been prevented by carefully reviewing bank statements and direct debit transactions. However, banks had received incomplete current account information. c) Some banks were found to have used pre-approved facilities, with the borrower being able to draw down lending without additional screening or checks.	a) Adding Single Name Concentration (SNC) or customer level limits to risk appetite or re-calibrated in relation to transaction volume and size. b) Introducing or recalibrating their hire purchase and finance lease lending limits. c) Introducing enhanced controls to review detailed bank statements of applicants for any new facilities as part of the Know Your Customer (KYC)/underwriting process. d) Introducing new controls or thresholds so that any material variation from the documented capital expenditure would trigger additional reviews of further drawdowns.

<table>
<tr><th>Detailed findings in reports</th><th>Key actions being taken by banks</th></tr>
<tr><td>b) Asset inspections and supplier vetting</td><td></td></tr>
<tr><td>Asset inspections
There are two stages of Asset Inspection (AI):
• asset valuation during initial under-writing; and
• asset inspection when monitoring on a regular basis for existing facilities.
Both were either relaxed or suspended by most of the banks during Covid-19 and for some banks they had not been undertaken for a number of years.
Banks found their AI policy guidelines were sub-optimal with shortcomings in the following areas:
a) the same serial number was used for financing transactions multiple times and risk controls did not spot this;
b) the absence of clear materiality thresholds (ie by asset value or type) for undertaking physical and virtual inspections;
c) a lack of drawstops (ie actions to block further drawings until certain conditions are met, for example satisfactory periodic AI);
d) unclear guidelines on the frequency of AI;
e) a lack of utilisation and guidelines for out-sourced asset inspections (sub-hire audits); and
f) banks were frequently informed assets were not on-site but at a broadcasting location, preventing AI and these were not followed-up.</td><td>A number of banks have already implemented a series of improvements in their AI policy by:
a) checking the original manufacturer invoices/delivery notes for serial numbers being applied/used for the assets more carefully, or looking to engage directly with the manufacturer;
b) introducing or tightening the materiality thresholds and frequency for AI (eg assets valued > £X to be chosen for annual physical inspection and/or virtual inspection);
c) introducing sampling and other risk-based approaches (eg increased frequency of inspection of higher risk assets or higher risk sectors);
d) checking conditions have been met (eg AI) on further drawdowns; and
e) enhancing guidelines for outsourced asset inspections.
Another option being considered is having Global Positioning System (GPS) location trackers attached to the asset to show actual location and proof that it exists.
Note: there are potential cost implications for some actions that need to be balanced against the return.</td></tr>
<tr><td>Supplier vetting
a) The main supplier for Arena was a sole trader and was not regulated by the Financial Conduct Authority (FCA). In addition, the supplier was not an authorised dealer registered with the Original Equipment Manufacturer (OEM) (eg Sony).
b) Banks identified gaps in their own supplier approval process.</td><td>Overall, banks have introduced higher levels of engagement with OEMs and additional due-diligence on the checking of invoices (inclusive of serial number verification), supplemented by comprehensive AI. This includes:
a) tightening of asset supplier controls by mandating companies are either regulated by the FCA or an authorised dealer of the OEM;</td></tr>
</table>

Detailed findings in reports	Key actions being taken by banks
c) Banks found that 'Supplier On-boarding Processes (SOP)' were inadequate focusing mainly on Anti Money Laundry (AML) and identity checks rather than trying to identify disproportionate level of assets dealt with by a small sole trader. d) Banks noted that there was no way to validate supplier provided asset serial numbers on invoices unless the asset numbers were verified with the manufacturer.	b) introducing materiality thresholds (eg if asset value > £X) to contact the OEM to validate invoice amounts; c) paying the global manufacturers (OEMs) or their UK subsidiaries directly; and d) where 'non-OEM' suppliers are used, introducing differentiated risk appetites to increase controls.
c) In-life account management and roles and responsibilities	
In-life account management Multiple short-comings were observed on in-life account management capabilities which created lack of oversight on customer behaviours, such as: a) A lack of a portfolio management view due to borrower account details not being considered at an aggregated level. b) A lack of robust challenge and control checks on long standing arrangements and patterns of transactional activity between borrower and supplier. Some banks were aware of some mismatches being identified by the KYC process, where data was different from the actual bank account transactions, however typically no actions were taken. c) In-life monitoring was found to be inconsistent across various portfolios of assets. For some asset types, banks utilised an active ongoing monitoring approach. For others, such as Hire Purchase, banks used a more hands-off approach, focusing on the annual relationship review or when the individual contract was in collections. d) The borrower was found to have several revolving credit facilities (allowing further draw-downs) and banks did not have robust control processes in place to monitor these.	a) Implementing or enhancing the existing in-life portfolio management framework (eg some banks increased focus on understanding customer behavioural activities and embedding those into in-life portfolio management and annual review frameworks). b) Increasing relationship managers' focus on understanding customer transaction activities and behaviours against expectations. c) Ensuring in-life monitoring processes are consistently robust across different asset types. d) Enhancing controls and monitoring over revolving credit facilities and assessing the potential gap in equity for such facilities.

<table>
<tr><th>Detailed findings in reports</th><th>Key actions being taken by banks</th></tr>
<tr><td>Roles and responsibilities

Arena was found to manage lenders’ relationships with a single point of contact who was able to control the level and type of information provided to lenders.

a) Departmental silos in banks were found which led to independent but disjointed reviews, a lack of coordination and information sharing in some banks in particular, which led to a poor control environment.
b) Banks identified some overlap and unclear roles and responsibilities across different departments (eg Relationship Managers, Credit Sanctioners and Second Line functions).
c) Potential conflicts of interest and lack of segregation of duties.
d) A lack of a portfolio management team to guarantee sufficient control, oversight, and challenge, especially for the asset finance book. This resulted in the relationship management team undertaking second line risk oversight responsibilities, in conflict with its primary focus of expanding the balance sheet.
e) Unclear roles and responsibilities for the monitoring of borrower activities (eg borrower transaction information was often available in-house, but was not used by the sanctioning team during the underwriting process).</td><td>a) Introducing policy changes to develop multi-point contacts with borrower’s businesses during underwriting and in-life account management.
b) Undertaking reviews of the roles and responsibilities of the Relationship Managers, Credit Sanctioners and Credit Analysts; and enhancing the information sharing across teams when reviewing credit applications.
c) Enhancing the role and responsibilities of the second line risk oversight to ensure robust controls are in place.</td></tr>
<tr><td>d) Automated transaction monitoring and data capabilities</td><td></td></tr>
<tr><td>Automated transaction monitoring

Banks were unable or had failed to cross-check transactions between the supplier and borrower (eg the lending was transferred to the borrower instead of OEM). However, recognising that:

a) In this event, the borrower maintained moderate levels of transactions over a long period of time to mask the situation. Nevertheless, as explained above, different alerts received by banks on ‘suspicious’ activities (eg mismatch observed on bank account transactions with annual financial reports) were ignored.</td><td>a) Banks already using automated transaction monitoring are reviewing their thresholds and improving their oversight controls.
b) Banks without automated transaction monitoring are considering implementing automated controls and embedding the process across all functions (ie frontline, second line and portfolio management).</td></tr>
</table>

Detailed findings in reports	Key actions being taken by banks
b) Transaction alerts weren't automated in some cases and there was no visibility to compare multiple sources of information relating to the borrower to identify anomalies. Automated transaction monitoring as a BAU function used for Relationship Managers' (RMs) customer understanding and actions on any alerts is key to mitigate such events in future	
Data capabilities Individual lenders were unable to assess the real exposure of the borrower spread across other lenders to inform their under-writing decisions. This is because, unlike retail lending, asset finance lending data does not get shared across lenders either through a Credit Bureau or in another single view form. Asset finance data was registered within the Hire Purchase (HP) central database or in the Companies house data if the loan is secured by a Chattel Mortgage only in limited cases. Other findings were: a) Some banks recognised their under-utilisation of available data during their under-writing and facilities management process (eg early warnings of mismatch of financials between CAIS (Credit Bureau) data and the borrower's published annual reports). b) Some banks didn't have a process in place to compare external data with borrower information. c) Only a few banks were able to apply their judgement and decline lending as a result of various triggers: • difficulty in performing regular asset inspection; • continual appetite for new lending with multiple brokers (in place of one trusted broker); • lack of price sensitivity to deals being financed; and • change in accounting reference date. These banks were able to decline new business and reduce exposures with the specific counterparty.	Banks are enhancing their data capabilities in different ways: a) Banks are in discussion to improve industry wide asset registration, possibly with an extension of the HP database. This will help stop funding the same physical assets multiple times. b) Improving data capabilities by switching to a multi credit bureau approach to access more comprehensive CAIS data. c) Identifying enhancements such as the wider use of data sharing via external credit agencies (eg Experian/CAIS) which could assist in cross referencing prospective customers/borrowers' reported financial positions. d) Enhancing underwriting data capabilities by mandating usage of multiple external data sources into the decision making process.

<table>
<tr><th>Detailed findings in reports</th><th>Key actions being taken by banks</th></tr>
<tr><td>e) Industry engagement and fraud control framework</td><td></td></tr>
<tr><td>Industry engagement
Banks recognised this event as a systemic issue across the asset finance industry. They identified multiple areas where industry level engagement and actions should be enhanced.
a) The lack of asset finance industry-wide information sharing and common registers like the HP register makes it harder to avoid systemic risk. Banks recognised the need to engage on an industry wide basis for the creation of an asset register which would ensure authenticity of assets as securities and protect from any duplicate or false references in asset based lending.
b) The asset finance industry operates on a bilateral funding basis. Banks recognised that industry level engagements would help avoid an Arena type of situation, providing a more customer centric view across all lenders/arrangements and avoiding a solely bilateral contract view.
c) Industry wide engagements on fraud prevention was identified as a shortcoming. Banks understand the need for collaboration within the industry by engaging with the Finance & Leasing Association (FLA) and technical partners on a possible suspicious activity alert service solution for mitigating against systemic risk.
d) Banks highlighted the lack of asset registration for non-vehicle assets as a key factor contributing to this case.</td><td>a) The FLA is establishing a fraud prevention working group to coordinate work across banks on fraud control. This will allow relevant information to be collated and analysed and shared between member banks.
b) A possible suspicious activity alert service solution is in the process of being developed and members are kept updated via the FLA Fraud and Financial Crime Working Groups. The work also covers the following areas:
• enhanced reporting by creditors into Credit Reference Agencies;
• greater sharing of borrower activity (noting that there are many GDPR areas of concern to consider);
• greater involvement of FLA members’ fraud teams to share intelligence; and
• encouragement of use of Fraud Prevention Agencies (FPAs) across members which would identify discrepancies/inconsistences across applications.
c) Consideration of a central non-vehicle database/register.</td></tr>
<tr><td>Fraud control framework
A weak fraud control environment and awareness led to early warning indicators not being recognised.
a) It was acknowledged by banks that fraud control and reporting processes require further enhancements by leveraging data, alerts and systems.
b) Banks noticed there was a lack of overarching fraud controls; although individual transaction level fraud controls were active.
c) Banks observed a general lack of wider staff awareness on fraud controls.</td><td>a) Developing an overarching macro view of the fraud risks in relation to individual transactions.
b) Formally reviewing their operational risk framework.
c) Enhancing and extending fraud training for Credit, Front Line and Operations teams focusing on analysing invoices and how to spot warning signs.</td></tr>
</table>