Bank of England PRA

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Chief Risk Officers

[All lenders on PRA Website and via Reg Digest]

Laura Wallis, Director
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Prudential Regulation Authority

10 September 2024

[Dear Chief Risk Officers]

Thematic findings of Internal Audit Review of the Credit Risk Management Framework – non-systemic UK Deposit Takers (UKDT)

I am writing to you to share the findings of a review, in which we asked the Internal Audit function (IA) of a selection of UKDT non-systemic banks and building societies to undertake a review of their Credit Risk Management Framework (CRMF). We would firstly like to thank participating firms' IA functions for their work on this review.

This review resulted from the high level of uncertainty in the macroeconomic environment[1] and the expected deterioration in credit portfolios. It was designed to provide assurance to the firms' Boards and to us on the overall effectiveness of the control framework and in the specific areas of focus, which were the governance and control environment over credit and affordability assessments, approval processes and portfolio management. The IA functions were asked to determine if current controls and practices are sufficient to mitigate the risks associated with these key areas of credit risk management.

We selected 33 UKDT non-systemic banks and building societies to take part in this exercise and to submit the IA report by 30 September 2023. The firms in scope represented 13% of non-systemic firms' lending exposures; six were banks and the remainder building societies. 81% of the firms in scope had a lending book of less than £1.5 billion; of which 44% had less than £0.5 billion. The majority (90%) of the IA

[1] www.bankofengland.co.uk/prudential-regulation/letter/2024/uk-deposit-takers-2024-priorities.

reviews were conducted by external audit firms. This letter summarises the findings from this review.

In your role as the Senior Manager[2] (SMF4: Chief Risk Function) responsible for identifying, assessing, and mitigating risks to the business, and a source of independent challenge, we consider that you are well placed to assess how the points below relate to your business and review how they are being addressed.[3]

Main observations

Our review of **236** IA findings shows the highest proportion of findings being rated as **Yellow**[4] (53% moderate breaches of control procedures). A smaller proportion were rated **Amber** and **Red** (14% significant and less than 1% materially significant control weaknesses). Therefore, an estimated two-thirds of the findings relate to notable breaches of rules around lending. Our observations reinforce the need for some firms to continue to enhance their portfolio management controls and affordability assessments, with consideration of changes in the macroeconomic environment to ensure that new lending is sustainable.

We observed the areas needing improvement (in priority order based on the number of findings) to be:

a) **Affordability assessment:** the need to improve the controls around the refresh of rules, buffers, judgements and/or data to reflect changes in macroeconomic or market trends more quickly. For example, frequent regular updates of Office of National Statistics (ONS) expenditure data, review of the stress rates applied, review of latest income rules in relation to market trends such as high inflation and high interest rates.

b) **Quality assurance (QA) and underwriting process:** the need to enhance QA controls. For example, some firms had QA being performed by just one of the two Lines of Defence ('LOD'), either by 1LOD or by the 2LOD; a few firms need to design and implement the QA process or need to enhance the frequency of the reviews performed; some firms had not fully documented their QA processes in Policies or Operations manuals.

c) **Quality of management information (MI):** suggested enhancements include having forward-looking MI; adding supporting commentary to charts and trends;

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[2] www.prarulebook.co.uk/pra-rules/senior-management-functions/25-09-2023.

[3] The PRA's requirements on senior managers at banks and PRA-designated investment firms are set out in the Senior Management Functions and Senior Manager Conduct Rules Parts of the PRA Rulebook. The PRA sets expectations in respect of these requirements in SS28/15 – Strengthening individual accountability in banking: www.bankofengland.co.uk/prudentialregulation/publication/2015/strengthening-individual-accountability-in-banking-ss.

[4] Red – material breaches/control weaknesses, Amber – significant breaches/control weaknesses, Yellow – moderate breaches/control weaknesses and Green – minor breaches/control weaknesses.

including more relevant metrics at board level on quality of new lending; quality of stock and book performance. Auditors also identified an absence of risk appetite metrics in the MI; inconsistency in the portfolio monitoring MI; and data reporting issues.

d) **Credit risk appetite (CRA):** the need to calibrate appropriately the CRA limits; to align the CRA with the latest business strategy and lending and collections policies; to create a CRA that is sufficiently granular to support the understanding of the asset quality of the lending book, and in the case of identified breaches; to have an escalation mechanism and process in place. The auditors also identified discrepancies between the Credit Risk MI, Credit Risk Appetite Statement and Lending policies; in addition, certain CRA limits were not included in the Credit Risk MI and hence not appropriately monitored.

e) **Lending policy:** the need to enhance the governance and control processes around the lending policy. For example, to include a limit on the volume/proportion of exceptions relating to ‘out of policy’ loans; to make sure the policy reflects the latest business strategy (that is regular updates to policy, in particular when there is a change in strategy) or describe in detail existing processes in place (i.e. an ‘out of policy’ exception process being in place but not documented or lending authority mandates being insufficiently detailed).

f) **Collections:** the need to have in place detailed contingency plans. For example, policies should include a clear resource management plan should customers in financial difficulty and/or arrears cases increase. Early Warning Indicators should be in place to identify deterioration in higher risk/vulnerable customer segments. In response to the current macroeconomic environment and the cost of living challenges, a proactive contact strategy should be in place for the identified higher risk/vulnerable customers.

Next steps – action for all firms

We recommend you use the points outlined in this letter as a reference when you next review and assess your own CRMF controls and potential areas that might need strengthening.

Yours sincerely

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