Good Practice Lending Guide

RM14 Provisions and Write-off

September 2025

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Laws and regulations can change. While this Guide is reviewed periodically, it may not always capture the latest developments.

For the most up to date information, please refer to the relevant official sources, including (but not limited to):

- **Financial Conduct Authority (FCA)**
  - FCA Handbook
- **UK Government**
  - Government policy papers and consultations
  - Credit union common bond review
- **Bank of England / Prudential Regulation Authority (PRA)**
  - PRA Rulebook for Credit Unions
  - PRA Supervisory Statements for credit unions
  - Policies relating to credit unions
  - Annual Assessment of the Credit Union Sector
  - Regulatory expectations
- **UK Legislation**
  - The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 – (see RM6)
  - UK's Data Protection – (see RM 12)
- **Financial Reporting**
  - Financial Reporting Standards (FRS) – (see RM14)

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1 Introduction

1.1 What is provision and why is it important?

For any lender, be it the largest bank or the smallest credit union, there are always some borrowers who fail to repay what they borrow. If, after all recovery options have been exhausted the loan is eventually classified as bad debt and written-off, then the lender incurs a loss.

To avoid overestimating how much income they will receive on the outstanding loans in their portfolio, lenders need to estimate the amount of bad debt they expect to incur in the future. This estimate of future bad debts is termed "A provision charge for bad and doubtful debts." Also known as an "Impairment charge."

Take a simple and simplistic[1] example of a customer with an outstanding debt of £1,000 who misses a repayment and enters arrears. The lender estimates there is a 25% chance of the loan never being repaid resulting in the loan being written-off. Therefore, the lender makes a provision of £250 (25% * £1,000) against the potential loss that may result.

In terms of how the provision impacts a lender's accounts, the £250 provision is treated as if the loss has already happened. The impact of making a £250 provision is to reduce the lender's profits by that amount even though the loan has not yet been written-off, and may never be, if the account recovers to a good paying status.

If the loan is eventually written-off, then the provision is set to zero and is replaced by the actual write-off amount. Consequently, if a lender maintains an accurate view of their provision, then, when a debt is written-off, there is no change to the firm's profitability. For the previous example, a prudent lender would increase the provision on the loan as the case moves further into arrears, eventually assigning a provision equal to the full £1,000 outstanding as the case approaches write-off. Similarly, if a loan recovers and moves towards an up-to-date status, then the provision charge will be reduced.

In practice, the calculation of provision is more detailed than this simple example, but the core principle of putting money aside to cover bad debt losses that you expect to occur in the future underpins all prudent approaches to provision calculation for consumer lending.

Provision has a direct impact on profitability. Under-estimate provision and profits will be inflated. Over-

[1] This not quite how provision would be calculated under the FRS, IAS and IFRS accounting standards which will be discussed later.

estimate provision and the firm's financial performance will appear worse than it is, resulting in the business being undervalued.

In the past, there have been cases of lenders deliberately under-reporting provisions to boost profits which have ultimately resulted in firms going bust when this practice has come to light, with company directors fined substantial sums and being banned by the regulator[2]. Consequently, for an organisation to be acting in a financially prudent way, which complies with the principle of business as described in the FCA handbook[3], it is important that provisions are calculated accurately.

In the Community Finance sector Fair4All Finance has observed examples of lenders significantly under provisioning their book, not having policies documented and together these leading to significant consequences in terms of their viability. These observations have occurred in both CUs and in CDFIS. Two anonymised examples are included below:

- eg pre-covid a community lender realised that it had significantly under provisioned its book. It addressed this, and only just managed to stay operational by taking over £250k of its crystalising bad debt losses out of its reserves – this accounted for more than 80% of the total reserves; ceasing taking on new customers and only issuing top up or repeat loans to very reliable customers, significantly curtailing its growth ambitions; making some staff redundant and asking others to work part time or on a voluntary basis. It was also brought into very close supervision by the regulator. Five years later it is still slowly recovering
- eg a community lender that piloted lending online via a price comparison website and didn't have controls in place to make sure that the customers automatically approved were in line with its stated criteria experienced a significantly higher bad debt rate than on its core book. At the time it had no documented provisioning policy and no monitoring of the ad hoc policy stance it had adopted to date so it also had no accurate baseline against which to monitor the actual performance that arose from that new lending. This also created significant cost and operational challenges

1.2 Why has Fair4All Finance commissioned this guide?

In our work with community finance lenders, those we have made significant investments into, and those we have funded through grants and capability support, we have come across a range of approaches to credit risk and provided consulting support to enhance them in many instances. This guide reflects our

[2] For example, see the case of Cattles and its subsidiary Welcome Finance. The company manipulated customers' account records, to make them appear to be up to date when they were in fact in contractual arrears, and hence did not hold sufficient provision against these accounts to the order of £261m. https://www.fca.org.uk/publication/final-notices/cattles-ltd.pdf
[3] The FCA's principles 1 through 4 relate a firm operating with integrity, care and due diligence with appropriate risk management controls and financial prudence.

intention to document what good practice looks like on provisioning and write-off to share the insight that has been developed for specific lenders more broadly.

1.3 Purpose of this document

This document is intended to support Community Finance lenders in setting aside provisions to accurately reflect the expected losses that they incur from unpaid loans, resulting in bad debt being written-off as a loss.

Every lender has their own provisions and write-off policies. However, it is important that firms clearly define and comprehensively document their methodologies for provision and write-off, to ensure they are running their business in a prudent manner and that this is reflected in their accounting practices.

The approaches to provision and write-off described here are generally applicable to all UK lenders, but it is primarily intended for small to medium sized organisations who are working to provide fair and affordable credit to sectors of the community who may otherwise struggle to obtain it. For example, not-for-profit lenders and credit unions. Therefore, it adopts a proportionate approach suitable for these types of organisations.

Organisations can use the Guide in one of two ways:

1 As a reference manual, to help them enhance their own lending policies and to provide assurance that there are no gaps or shortcoming

2 To support new organisations in setting up appropriate credit risk-based lending policies

The focus of this document is provisions and write-off. However, there are clear overlaps with other areas of lending, such as arrears processing, management Information, governance etc. These are signposted within the relevant sections throughout this guide.

2 Scope

This document covers:

- The different methods organisations can apply when calculating their provisions.
- The conditions under which an organisation should write-off bad debts.

In the rest of this document, we start by discussing minimum provision requirements for credit unions as specified by the PRA. We then present the two ways in which other lenders can calculate their provisions under the FRS (UK GAAP) and IFRS accounting standards. Finally, we discuss when loan assets should be written-off.

The main body of the document concludes with two examples. One covering a credit union and the other a commercial lender.

3 Provision calculation for credit unions

3.1 PRA minimum requirements

The PRA specifies the *minimum* provision requirements for all credit unions in the PRA Rulebook. These are provided in sections 3.11 and 3.12 [4]as detailed below:

3.1.1

03/02/2016

A ***credit union*** must make specific provision in its accounts for ***bad debts*** of at least the amounts set out below:

1. (1) 35% of the ***net liability*** to the ***credit union*** of borrowers where the amount is more than three months in arrears;
2. (2) 60% of the ***net liability*** to the ***credit union*** of borrowers where the amount is more than six months in arrears;
3. (3) 80% of the ***net liability*** to the ***credit union*** of borrowers where the amount is more than nine months in arrears; and
4. (4) 100% of the ***net liability*** to the ***credit union*** of borrowers where the amount is more than twelve months in arrears.

3.1.2

03/02/2016

Where a delinquent loan is rescheduled or the arrears capitalised, the provision a ***credit union*** is required to make immediately prior to the rescheduling or recapitalisation must be maintained until the loan has performed for six months.

In relation to 3.11:

- Net Liability means the outstanding balance of any loan made to a borrower and any interest or

[4] https://www.prarulebook.co.uk/rulebook/Content/Chapter/320142/21-10-2023#320217

charges on that loan that are due but unpaid, less any attached shares held by the borrower, ie, less any savings that the borrower has with the credit union

- Arrears should be measured against the original contractual repayment schedule. For example, if the customer should have made 6 monthly payments by reporting period X but their total repayments is only equivalent to 2 monthly repayments then they would be classified as 4 months in arrears. It is important that the transparency of these calculations is maintained especially when top up loans are involved as this can distort and skew reporting and treating this opaquely is problematic under audit.

Example:

- A customer takes out a £2,000 loan repaid over 2 years
- The customer has £200 in credit union savings (shares)
- The customer made 7 repayments, before entering arrears. They have made no further payments since then
- The customer is currently 4 months in arrears and the current amount owing on the loan is £1650

The net liability is calculated as:

£1,650 – £200 = £1,450

Given that the customer is 4 months in arrears, provisions are calculated as 35% of the net liability, ie, 35% * £1,450 = £507.50.

3.2 Calculation of additional provision requirements

The PRA Rulebook specifies the minimum requirements for provision and in most cases using the PRA supplied values provide sufficient provision coverage. However, if a credit union believes that this will result in an under-estimate of future losses, then it should consider allocating additional provision. Examples of when additional provisions may be appropriate include:

- Where the credit union has evidence that the provision levels specified by the PRA result in an under-estimation of eventual write-off. For instance, analysis of loans that were 3-5 months in arrears historically shows the write-off rates for these loans averages 40%. Therefore, a value of 40% is used instead of the 35% value stated by the PRA
- Where there are circumstances indicating that higher provisions are appropriate in certain situations. For example, cases of suspected fraud will usually move quickly to write-off. Therefore, regardless of their arrears status they are assigned a 100% provision prior to write-off
- Customer circumstances, such as serious illness, imprisonment, bankruptcy or leaving the country, indicating that the loan is unlikely to be repaid even if the loan is not currently in arrears

In assessing additional provision requirements a credit union may also calculate provisions in a way that aligns with the FRS or IFRS accounting standards, which are discussed in Section 4 and Appendix A respectively. If the provision calculated using one of these methods exceeds the PRA minimum, then that value is used instead.

3.3 Management overlays

A management overlay[5] is an additional amount of provision an organisation allocates to cover losses that they believe may occur, but which are not accounted for using the lender's standard provisioning methodology. This can cover similar situations as those discussed in Section 3.2 for specific exposures but can also be based on general market and/or company conditions. Some reasons for management overlays include:

- **General macro-economic downturn.** A lender will increase provisions in anticipation of a worsening economic environment
- **Micro-economic (common bond related) circumstances.** Conditions that directly impact the target customers. For example, a regional or industry related issue that is likely to lead to a significant increase in unemployment and/or financial hardship within the community that the organisation serves. The IFRS9 method discussed in the appendix, which is typically appropriate for larger organisations, suggests that multiple scenarios can be run to project future provisions and this kind of consideration of multiple scenarios could also be considered as management considers what overlay to also add into its approach for a particular economic cycle. The Fair4All Finance scenario planning guide [6]may be useful in this process.
- **Identification of new risks.** There may be certain types of customers, new products, or new lending procedures where the organisation has not yet been able to develop a standard provisioning approach. Therefore, an amount of provision is assigned to cover these risks temporarily.

Regardless of their source, management overlays should only be considered as a temporary measure, to address shortcomings in the firm's general approach to provision calculation. The overlays are removed once the shortcomings have been addressed. They may also lead to updates in the provisioning policy if it is deemed prudent to incorporate the management overlay in an update to the policy on a permanent basis, eg in creating a differentiated provisioning policy for a new product type when the management overlay during a testing period has proved a sensible rule to maintain.

[5] For organisations that rely on provision models, this is sometimes referred to as a Post Model Adjustment (PMA).
[6] https://fair4allfinance.org.uk/wp-content/uploads/2021/02/Affordable-credit-Navigating-uncertainty-and-growing-community-finance-Final.pdf

4 Financial reporting standards (FRS)

In this section, we describe how provision should be calculated under generally accepted accounting practice in the UK, as described in the Financial Reporting Standards (FRSs) maintained by the Financial Reporting Council (FRC).

The Financial Reporting Standards are typically applied by small-medium sized lenders[7]. Larger lenders, such as the main Banks and Building Societies normally calculate their provisions to the more complex IFRS9 standard (Which replaced the IAS39 standard in 2018). An overview of IFRS9 is provided in Section 5.

4.1 FRS102 & IAS39

Under FRS102, firms are given the option to calculate provisions using either the FRS102, IAS39[8] or IFRS9 accounting standards. Organisations that use FRS will state in their accounts that they report to FRS standards, but then add a statement to confirm if they are applying one of the other standards for provision. In practice, most smaller organisations, such as CDFI's, credit unions, and small to medium size building societies, adopt, or voluntarily adopt, FRS102 or IAS39 for provision calculation rather than the more complex IFRS9.

In general, IAS39 provides some additional flexibility in accounting policy compared to FRS102. This is why some organisations choose to adopt it rather than just applying FRS102. However, when it comes to consumer credit and personal loans, provision calculations under FRS102 and IAS39 are virtually identical. Given that this document is focused primarily on personal loans, going forward we'll consider the FRS102/IAS39 approaches to provisions to be one and the same.

FRS102/IAS39 adopts an "Incurred Loss" model for calculating impairment. This means that provision is only calculated for loans where there is an indication that the loan is not performing (impaired) and is

[7] These are based on the International Accounting Standard's Board (IASB's) International Financial Reporting Standard for Small and Medium-sized Entities. However, they have been significantly amended for use in the UK.
[8] For example, Furness, Loughborough, Marsden and Cumbernauld building societies report their accounts under FRS102 but apply IAS39 for provisions.

therefore believed to be more likely to incur a loss than when initially booked.

4.1.1 Definition of impairment (non-performing)

Each lender is responsible for determining how it defines impairment (a non-performing loan). However, for firms adopting the FRS102/IAS39 approach, the primary indicator of impairment will be missed payments, ie, a customer's account is in arrears.

However, there can be other indicators of impairment. This includes forbearance measures or where a customer notifies the lender that they are unlikely to be able to fully meet future repayments or where the customer has been declared bankrupt.

4.1.2 Provision calculation under FRS102/IAS39

A simple approach to calculating provision is to base loss estimates on historic performance. If a lender has observed that for loans that are 3 months in arrears, on average 65% of the outstanding debt is eventually repaid due to the account recovering or because of debt collection action, then the provision is simply set to 35% of the outstanding loan value. This is effectively the approach that the PRA has taken in specifying minimum provision requirements as discussed earlier in this document.

However, under UK FRS accounting standards, provisions should be calculated based on "amortised cost using the Effective Rate of Interest (EIR)[9]" In common parlance, this means that when calculating provision lenders need to:

1 Consider the repayments that should have been made over the remaining term of the loan, including interest and other charges.

2 Discount the expected recoveries to take into account the fact that the further into the future money is obtained, the less value it has as at today – which is referred to as Net Present Value (NPV). The discounting should be based on the Effective Interest Rate (EIR) which for most consumer loans is approximated using the interest rate charged on the loan[10]. This approximation will be used in the examples presented in this document.

The following example illustrates how this calculation is undertaken.

Imagine a customer who has taken out an unsecured loan for £20,000 to be repaid in 48 equal instalments over a term of 48 months. The contractual rate of interest on the loan is fixed at 9 percent. After making 24 payments, the customer misses a payment, enters arrears and the account is classified as impaired. Details of the customer's repayment schedule, interest charges and outstanding balance are shown in

[9] Paragraph 11.14(a) of FRS 102

[10] This approximation assumes that the only charge on the loan is a fixed rate of interest applied over the loan term, resulting in the EIR and the contractual interest rate being materially the same. If the loan includes arrangement, documentation or other one-off fees, then a separate EIR calculation may be required.

Table 1.

Table 1 Customer repayment schedule

Month	Outstanding balance (£)	Interest added (£)	Payment (£)	Post payment balance (£)
1	20,000.00	144.16	494.38	19,649.78
2	19,649.78	141.64	494.38	19,297.04
3	19,297.04	139.09	494.38	18,941.75
…	…	…	…	…
…	…	…	…	…
23	12,494.58	90.06	494.38	12,090.26
24	12,090.26	87.15	494.38	11,683.03
25	11,683.03	84.21	494.38	11,272.86
…	…	…	…	…
…	…	…	…	…
47	978.17	7.05	494.38	490.84
48	490.84	3.54	494.38	0.00
Total		**3,730.24**	**23,730.24**	

Note: Interest added = outstanding balance * (1+contractual interest rate)$^{1/12}$

From Table 1, after the customer has made 24 repayments the outstanding balance at the start of month 25 is £11,683.03.

From previous experience, the bank estimates it is likely to recover 90 percent of the outstanding debt from customers who are 1 month in arrears by the end of the loan term, with the remaining 10 percent of the outstanding debt being written-off. Therefore, the bank expects to receive 90 percent of the £11.683.03 owing; that is, £10,514.73. This amount is then subject to the net present value calculation over the two remaining years of the loan. The NPV is calculated as follows:

$$NPV(£X) = £X / (1+A)^n$$

Where:

*£X i*s the amount recovered.

A is the effective interest rate charged per reporting period

n the number of periods over which to discount

Using the NPV formula with our example gives:

$$NPV(£10,514.93) = £10,514.93 \ / \ (1+0.09)^2 = £8,850.04$$

The provision is then calculated as the difference between the amount owing and the NPV of the expected recoveries: £11,683.03 - £8,850.04 = £2,832.99.

The lender would also use this type of calculation for accounts in different arrears positions, but with reducing recovery percentages as the arrears becomes more serious.

In this example, the lender required the following information to calculate the provision.

1 The outstanding balance on the customer's account

2 The remaining term of the loan

3 The interest rate charged on the loan

4 The estimated probability (likelihood) of write-off occurring

5 The estimated amount written-off, should write-off occur

Items 1, 2 and 3 are generally known given that they are determined by the loan agreement. Items 4 and 5 are unknowns. Therefore, they are estimated using analysis of previously impaired loans and their behaviour over time. As an example, let's consider loans that are between 7 and 9 months in arrears (in line with the PRAs arrears categorisation):

- **Probability of write-off**: Looking at loans in different states of impairment as at say, 12 months ago and examining the proportion that were eventually written-off, it is observed that 85% have been written-off 12 months later
- **Amount written-off, should write-off occur**. As above but looking at the amount eventually written for loans that were 7-9 month in arrears say, 12 months ago. It is observed that 10% of the outstanding debt is recovered, with 90% being written-off

Therefore, for accounts that are 7-9 months in arrears that are eventually written-off, it is expected that the proportion of the debt that is written-off is 85% * 90% = 76.5% This value would then be applied to the outstanding balance of cases 7-9 month in arrears to calculate the expected loss, and this loss value is then used in the NPV calculation (as per the example based on Table 1).

4.1.3 Roll rate models for calculating the likelihood of write-off

In the previous example, where the write-off amount used in the provision calculation was estimated to be 76.5% of the balance, it was necessary to derive this figure using historic data from some time ago. This will often be at least 12 months in the past but could be much longer for some types of lending. Consequently, there is risk that the information becomes out-of-date in relation to the actual repayment performance at the current reporting period (as at today).

One tool that lenders use that enables them to use more up-to-date information in calculating the likelihood of write-off is roll rate analysis. Roll rate analysis is based on the change in states between the current and previous reporting periods, as illustrated in Table 2.

Table 2. Roll rate analysis.

		Current Reporting Period (Months in Arrears) % Movement										
		0 (Up to date)	1	2	3	4	5	6	7-11	Write-off	Total	Prob. eventual write-off
Previous Reporting Period (Months in Arrears) % Movement	0 (Up to date)	92%	8%	0%	0%	0%	0%	0%	0%	0%	100%	0.0%
	1	51%	19%	30%	0%	0%	0%	0%	0%	0%	100%	1.6%
	2	14%	31%	25%	30%	0%	0%	0%	0%	0%	100%	4.9%
	3	9%	4%	6%	27%	54%	0%		0%	0%	100%	16.3%
	4	4%	3%	4%	9%	21%	59%	0%	0%	0%	100%	30.1%
	5	3%	3%	2%	3%	4%	18%	67%	0%	0%	100%	51.1%
	6	2%	2%	2%	1%	2%	2%	7%	82%	0%	100%	76.3%
	7 - 11	1%	0%	0%	0%	0%	0%	0%	6%	93%	100%	93.0%
	Write-off	0%	0%	0%	0%	0%	0%	0%	0%	100%	100%	100%

In this example, the lender calculates provision based on arrears states, with write-off occurring once an account is between 7 and 12 months in arrears[11].

Table 2 has been produced by looking at the change in arrears states between the previous reporting period (previous month) and the current reporting period (current month). For example, for accounts that were up to date last month, 92% remained up to date and 8% missed a payment, becoming 1 month in arrears. For accounts already 1 month in arrears, 51% recovered to an up-to-date status, 19% remained 1

[11] The precise time being determined by individual circumstances related to the customer / loan, but it is never before 7 months and never longer than 12 months.

month in arrears and 30% rolled further into arrears. At the lower end of the table, 93% of accounts that were 7-11 months moved to write-off, with only 1% fully recovering and 6% remaining in arrears. The figure for write-off is 100% given that accounts cannot recover once write-off has occurred.

The way the roll rate table works, is that the probabilities of moving from each state can be combined to generate a probability of an account being written-off, given their current arrears status. The highlighted cells in Table 2 illustrate how this would occur for accounts that are 2 months in arrears. The final write-off probability is calculated as:

- (Probability of account 2m in arrears rolling to 3m in arrears)*
- (Probability of account 3m in arrears rolling to 4m in arrears)*
- (Probability of account 4m in arrears rolling to 5m in arrears)*
- (Probability of account 5m in arrears rolling to 6m in arrears)*
- (Probability of account 7-11m in arrears rolling to write-off)

Which is equal to:

- 30% * 54% * 59% * 67% * 82% * 93% = **4.9**%

Therefore, for accounts that are currently 2m in arrears as at today, the lender estimates that 4.9% of these cases will be written-off eventually.

The roll rate table is updated each reporting period, and the revised figures used to produce the relevant provision figures for that period. If data is sparse over a single reporting period, then lenders may produce the roll rate table based on rolls over longer periods to provide more stable measures. This is usually only an issue for small, or very high quality portfolios with fewer than ~10 cases in each arrears state each month.

Where other impairment conditions exist that are not defined by arrears status then similar approaches can be adopted looking at rolls to any intermediary states that exist, or the roll rates directly between that condition and write-off.

5 IFRS9

The International Financial Reporting Standard number 9 (IFRS9) was introduced in 2018 to replace International Accounting Standard 39 (IAS39) for most lenders. IFRS9 covers provision calculation, amongst other things.

Provision calculations under IFRS9 are an order of magnitude more complex than those under FRS (IAS39). Consequently, IFRS9 is normally adopted only by medium-large organisations with the necessary analytical and technical resources required to construct, manage, and maintain IFRS9 models. This includes all the main high street banks and the largest building societies.

In practice, there are very few not-for-profit lenders who currently apply IFRS9 or have plans to do so in the near future. Almost all smaller building societies, credit unions and CDFIs continue to apply IAS39/FRS102 within the FRS framework. Consequently, IFRS9 is not discussed further in the main body of this document, but further details are provided in Appendix A.

6 Write-off

When all reasonable channels for recovering an over-due debt have been exhausted the debt is written-off. This means that the outstanding debt is recorded as a loss and removed from the lender's balance sheet. Likewise, once the loss has been recognised then a provision is no longer required for that loan, ie, the provision is set to zero.

6.1 When to write-off

There are no specific UK regulations as to when write-off must occur. However, most organisations will seek to write-off unsecured debts when accounts are somewhere between 6 and 24 months in arrears.

Looking to the EU, some guidance that has been provided as to when write-off should occur is:

- The Central Bank of Ireland Provisioning Guidelines for Credit Unions[12] states that "where a loan is in arrears of 53 weeks or more, that serious consideration should be given to writing off that loan from the credit union's balance sheet (ie, thereby removing it from the balance sheet). Notwithstanding that a loan is written off, a credit union may of course continue to pursue recovery of that loan from a borrower in line with its credit control policy."
- European Central Bank Guidance to Banks on Non-Performing Loans[13] says that loans that are 2 years past due should be fully provisioned for, ie, no expectation of further recoveries. Therefore, they should be considered for write-off.

Regardless of when accounts are write-off, an organisation should have a clearly documented policy for the conditions under which write-off occurs, that is supported by appropriate management information to assess adherence to the policy.

6.1.1 DWP Eligible Loan Deduction Scheme (ELDS)

As described on the DWP website, the ELDS is a UK government initiative to support the expansion of affordable credit to people on low incomes. Under the scheme, the DWP can make deductions from benefits, in certain circumstances. Participating organisations are from the not-for-profit sector such as

[12] Central Bank of Ireland Provisioning Guidelines for Credit Unions. Section 3.11.
[13] Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures (europa.eu)

credit unions and Community Development Finance Institutions (CDFIs).

For lenders that join the scheme, they can refer serious arrears cases to the DWP when they have unsuccessfully tried to negotiate alternative repayment arrangements with the borrower. The DWP will then consider making deductions from the borrowers benefits to cover the debt. DWP repayments can be a very small proportion of the outstanding debt, meaning that debt deductions can continue for many years.

The process of joining ELDS is set out on the DWP website[14] - to utilise the scheme lenders must comply with a range of requirements including the inclusion of specific wording in the Loan agreement.

6.2 Recoveries post write-off

After write-off occurs, it is still possible that funds will be recovered. For example, continuing action by DCA's or following someone's death when the estate settles the outstanding debt.

If any funds are recovered following write-off, then this is treated as a receivable (that contributes to profits) and added back to the balance sheet (with a corresponding reduction in write-off).

6.3 Management reporting considerations

A lender's write-off policies will have an impact on the way that arrears and bad debt are reported. If the write-off period is too short, then the impact will be a reduction in the overall arrears and provisions of the portfolio that is not reflective of the true position.

Conversely, if write-off does not occur in a timely manner, or there are technical reasons that prevent write-off (such as on-going forbearance), then this can result in an overly pessimistic view of the arrears position of the portfolio being reported as bad debt continues to accumulate, becoming an ever larger proportion of the portfolio overall.

Consequently, good practice is to ensure that management reporting includes separate reporting that stratifies arrears by its severity. Reporting should also consider fully provisioned cases (provision equal to the full outstanding debt) as a standalone category when reporting portfolio arrears and default rates. Likewise, good practice is to produce cohort reporting, showing the arrears rate trends for accounts originating in different reporting periods, as well as a stock view, showing the current arrears position for the book as a whole.

Good practice for portfolio reporting is covered in more detail in the Portfolio MI module of the Good Practice Lending Guide.

[14] https://www.gov.uk/government/publications/eligible-loan-deduction-scheme

With regard to Consumer Duty, it is important for lenders to consider and evidence analysis of the common characteristics of groups of customers that are using a product within the portfolio that correlates with a persistent significant arrears state and/or high levels of write-off. This could be an indicator of unsuitability of the product for that cohort of customers' needs, that may be driving a poor outcome.

For example, when providing a fixed term loan at the outset of a credit agreement to individuals with erratic income and then subsequently informally or formally extending the term of the credit over a longer period outside of the original term to accommodate this. In this scenario they may eventually repay the outstanding balance but are technically in arrears and potentially could incur additional costs in interest and fees by moving into this arrangement. It brings into question whether the customer should be presented with alternative product options by moving from a direct debit fixed term loan to a more flexible revolving credit product that may provide a level of flexibility to better match the variability of their income. (Section 7.7 of the Consumer Duty references the obligations for firms to enable product switching to be easy for consumers. Section 11.33 also references the obligations for firms to look at whether customers are receiving worse outcomes because they are more likely to incur penalty fees by using a particular product that does not fit with their circumstances).

More information about Monitoring outcomes for the Consumer Duty can be found in Section 6 of Module RM7 Consumer Duty and Complaints Handling.

- Example provisions calculation

6.4 Example 1. A typical credit union

The All Welcome Credit Union (AWCU) provides unsecured loans to its members. It currently has a loan portfolio of approximately 3,000 loans, with a value of ~£6m.

As a small credit union, AWCIU has decided to base its provision calculation on the minimum provision requirement as detailed in the PRA Rulebook. The details of this calculation are provided in Table 3:

Table 3. Minimum Loan Requirement

Arrears status (Contractual months in arrears)	Number of loans	Loans balances	Provision allocation as % of balance	Total provision (£)
Up to Date	2,564	£ 5,128,072	0%	£-
1-2	202	£ 404,049	0%	£-
3-5	111	£ 222,028	35%	£77,710
6-8	61	£ 122,046	60%	£73,228

9-11	34	£ 68,035	80%	£54,428
12+	37	£ 74,044	100%	£74,044
Total	**3,009**	**£6,018,275**	**5%**	**£279,409**

From Table 3, the minimum provision requirement is £279,409.

In addition to the provisions in Table 3, AWCU makes provisions against the following cases:

- Declared bankrupts – 100% of outstanding debt
- Deceased – 50% of outstanding debt

For these cases, the provision is set to the highest applicable value. For example, if a known bankrupt is 1 month in arrears, then the 100% provision rule for bankrupts applies. For a deceased case that is 10 months in arrears, then the 80% PRA minimum applies (as per Table 3).

There are two cases of bankruptcy that AWCU are aware of with a combined balance of £5,500. Both these cases are currently up to date. Therefore, the provision is increase by £5,500 from £279,409 to £284,909.

At the Board regular board meeting, it is brought to the Board's attention that the major employer in AWCU has just announced a redundancy program that will result in about half of its staff being laid off. Given that about 30% of the credit union's members are employed by this employer, AWCU estimate that around 15% of the CU's members at risk of becoming unemployed.

Based on past experience, AWCU believes that unemployment leads to an additional 5%of outstanding balances being written-off where customers are not in serious arrears. Therefore, for accounts that are less than 3 months in arrears (have no provision assigned against them currently as per Table 4) it will apply a management overlay calculated as:

£5,754,222 (Sum of loan balances <3m in arrears) * 15% * 5% = £43,157.

This overlay will be reviewed each month, as further details of the redundancy programme emerge.

This leads to a final provision value of:

£279,409 (Minimum PRA requirement) +

£ 5,500 (Add on for two bankruptcy cases that are currently up to date) +

£ 43,157 (Management overlay for expected increase in unemployment) +

= £ 328,101

Therefore, the total provision is calculated as £328,101.

As the redundancy programme is implemented AWCU monitors what happens to its arrears. It seems

initially that this approach has been over-cautious as the provisioned amounts initially exceed what arises as many of the workers have an upfront redundancy payment and use this to clear out some of their debt whilst they look for new roles. But over time, the provisioning changes that have been made are found to be sensible. AWCU reflects on this data and attributes this to the number of workers whose remaining loan principal runs for a longer period of time – leaving it more exposed to those former employees who find payments more difficult to make the longer they are unemployed.

This analysis of provisioning enables AWCU to consider change to its collections policy. To manage these loans AWCU starts incurring more significant collections costs and recognises that what it needs to do is help the former employees to improve their circumstances as much as possible. The collections team starts to proactively advocate for benefits calculator tools being used by the former employees. This helps some of them significantly increase their monthly income and so improve the organisations collections performance. AWCU also improves the relationship they have with the local debt advice charity so that those who appear to be really struggling can be referred with a more personalised set of recommendations. Though this means that some customers end up in debt management plans and other formal and informal debt instruments AWCU has brought clarity to each of its loans sooner and curtailed its collections costs where more effort seemed unlikely to lead to repayment.

6.5 Example 2. A commercial lender providing unsecured loans under FRS102/IAS39

Lifeline Loans is a commercial lender who aims to provide affordable loans to customers who traditionally face financial exclusion from mainstream lender products. In preparing their accounts, Lifeline adopt the FRS102 standard, incorporating IAS39 for the calculation of provisions for impaired loans.

Lifeline consider accounts to be impaired once they are 1+ month in contractual arears and use a roll rate-based approach to produce an estimated probability of write-off as shown in Table 4.

Table 4. Roll Rate Analysis for Lifeline Loans

		Current Reporting Period (Months in Arrears) % Movement										
		0 (Up to date)	1	2	3	4	5	6	7-11	Write-off	Total	Prob. eventual write-off
Previous Reporting Period (Months in Arrears) % Movement	0 (Up to date)	88%	12%	0%	0%	0%	0%	0%	0%	0%	100%	0.0%
	1	48%	19%	33%	0%	0%	0%	0%	0%	0%	100%	2.0%
	2	14%	31%	20%	35%	0%	0%	0%	0%	0%	100%	5.3%
	3	8%	5%	6%	28%	53%	0%		0%	0%	100%	15.2%
	4	4%	3%	4%	9%	19%	61%	0%	0%	0%	100%	28.6%
	5	4%	2%	3%	2%	5%	14%	70%	0%	0%	100%	47.0%
	6	2%	2%	2%	1%	2%	2%	11%	78%	0%	100%	67.1%
	7 - 9	1%	1%	0%	0%	1%	0%	3%	8%	86%	100%	86.0%
	Write-off	0%	0%	0%	0%	0%	0%	0%	0%	100%	100%	100%
	Total											

Note: Lifeline writes off loans that exceed 9 months in arrears (270 days past due).

For loans that are written-off, Lifeline has analysed historic write-offs and calculated the proportion of the balance was written off, given the borrower's current arrears status. This is shown in Table 5.

Table 5. Observed Proportion of Balances Written-off by Arrears Status.

Arrears status	Write-off (% balance)
1	38%
2	41%
3	45%
4	49%
5	52%
6	57%
7 - 9	60%

Then, using information about the interest rate and the outstanding balance, combined with the analysis from Tables 4 and 5, Lifeline calculates the provision for each impaired loan as shown in Table 6.

Table 6. Account Level Provision Calculations

Acc.	Balance	Annual EIR	Monthly EIR	Remaining term (months)	Months in arrears	Est. write-off (% balance)	Est. recoveries	NPV (recoveries)	Loss (balance - NPV recoveries)	% chance write-off	Provision
1	£5,500	9.9%	0.79%	23	3	45%	£ 3,025	£2,524	£2,976	15.2%	£452
2	£556	14.9%	1.16%	5	7	60%	£ 222	£210	£346	86.0%	£298
3	£2,180	19.9%	1.52%	14	2	40%	£ 1,308	£1,058	£1,122	5.3%	£59
…	…	…	…	…	…	…	…	…	…	…	…
…	…	…	…	…	…	…	…	…	…	…	…
Total	£3,650,053							£131,407	£146,008		£292,004

As in the previous example with AWCU, Lifeline Loans also considers several additions to its base calculation to cater for cases such as bankruptcy and deceased.

In this example, an additional £14,450 is added for these types of cases.

The operations team have also identified 5 linked loans that it believes may be associated with sleeper fraud. This is where the loans are currently being repaid to build up a good credit record but are expected to default in the near future if further loan applications are declined. Indicators that may suggest sleeper fraud include; Customer's personal data is known to be compromised from a recent data breach, frequent requests to change key personal data on the account(s), and a sudden and frequent ramp up of transactions that max out the credit limit (particularly applicable to revolving credit accounts). Investigation into these accounts is on-going. Therefore, the relevant board sub-committee[15], decides that it should proportion a 100% provision against the £23,000 balances on these 3 loans until such time as their status has been confirmed. This brings the total provision to £292,004 + £14,450 + £23,000 = £329,454.

[15] This might be the risk committee. Alternatively, it may be a decision taken directly by the Board.

7 Appendices

7.1 Appendix A: IFRS9 – an overview

IFRS9 is a new accounting standard that was adopted in 2018m and was intended to replace IAS39 for most lenders.

IFRS9 is a significantly more complex and resource intensive approach to provision calculation compared to the "incurred loss" approach(es) used under the IAS39/FRS102 accounting standards but provides a more nuanced and "forward looking" view than IAS39, that has some similarities with the Internal Rating Based approach to calculating capital requirements. However, there is no barrier to any lender adopting IFRS9 if they wish, and it is good practice if an organisation has the resources to do so.

For some Fair4All Finance funded programmes we have partially adopted this kind of reporting as it has provided a way to give confidence to co-funders where they are in scope of IFRS9 and when we are piloting new products and it has proved useful in an adapted way in giving a very objective means of calculating and forecasting losses on programmes. In some cases we have operated a period of parallel calculations to assess what methods are most useful in understanding performance as it evolves over time.

IFRS9 also allows some simplifications for smaller organisations. The standard repeatedly refers to: "Without undue cost or effort" in terms of meeting the requirements. To put it another way, the level of detail that an organisation applies in complying with the standard should be proportional to the size and complexity of the organisation. However, the definition of "undue cost or effort" is not provided within the standard. It falls to each organisation to justify to themselves and their auditors the simplifications that they apply under the "undue cost or effort" clause.

The remainder of this section is intended to provide a high level overview of core principles of provision calculation under IFRS9. It does not constitute a detailed guide to calculating provision to the IFRS9 standard.

7.1.1 Expected Credit Loss (ECL)

IFRS9 is based on the concept of Expected Credit Loss (ECL). An ECL is calculated for every asset

regardless of if it is impaired or not[16]. The individual ECLs are then summed together to provide an overall provision estimate.

The ECL calculation for an asset is based on the following three elements:

1 The Probability of Default (PD), expressed as a percentage.

2 The Exposure at Default (EAD), expressed as a £amount.

3 The Loss Given Default (LGD), expressed as a percentage.

The ECL is then calculated as:

- £ECL = PD * EAD * LGD

Consequently, for organisations to be able to apply IFRS9, they need to be able to derive quantitative values of PD, EAD and LGD. These values are required at origination, at the current reporting period and over the remaining life of the loan.

Where do these estimates of PD, EAD and LGD come from? Many organisations use their operational credit scoring models as the basis for calculating PD, with appropriate modifications to generate lifetime estimates. For fixed term lending, EAD is the easiest value to calculate, as it can be derived from the deterministic repayment schedule. LGD is usually derived based on past loss experience, with appropriate modifications to cater for different customer segments, any security, and the future economic outlook.

This approach, using PD, EAD and LGD was deliberately chosen to better align with capital requirements calculations required for deposit taking institutions to cover *unexpected* losses. We recognise that it will be easier for organisations that raise capital externally to include the cost of capital in this calculation. For Credit Unions this is more challenging as capital almost exclusively comes from members where the only proxy for cost of capital available in this scenario is the dividend payments to deposit holders. These capital calculations also use a PD, EAD and LGD approach to loss calculation but there are some significant differences in how they are calculated and used compared to IFRS9.

[16] This can be at an individual exposure level, or at a pooled level for similar assets. However, for consumer lending common practice is to calculate ECL at asset level.

7.1.2 The 3 Stage Expected Loss Model

Under IFRS9, provisions are calculated based on the 3-stage model as shown in Table 7.

Table 7. IFRS9 3 stage model

	Stage 1	Stage 2	Stage 3
Driver	No significant increase in credit risk (PD) since initial recognition[17]	A significant increase in credit risk (PD) since initial recognition	Impaired (in default)
ECL time horizon	ECL resulting from impairment that occurs in the next 12 months	ECL over the remaining life of the loan (incorporating any recoveries post lifetime)	ECL over the remaining life of the loan (incorporating any recoveries post lifetime)
Calculation of interest	EIR on carrying amount	EIR on carrying amount	EIR on amortised cost carrying amount

The key difference between Stage 1 and Stage 2 is that for an account in Stage 1, losses are only calculated based on the probability of default (impairment) occurring in the next 12 months. Once an account is in Stage 2, then losses need to be considered over the remaining life of the loan.

An account moves from Stage 1 to Stage 2 if there is a "significant increase credit risk." This is usually based on the change in the estimated lifetime probability of default between when the asset was originally recognised and the current reporting period[18].

[17] "Initial recognition" is usually when a new loan is granted and added to a lender's portfolio. However, it can also to other ways in which a loan can be added to a portfolio, such as through the purchase of a loan book from another lender.
[18] The standard also includes some "backstop" conditions such as an account should move to stage 2 if it is more than 30 days in arrears. Likewise, an account should be classified as impaired once it is 90 days past due.

In determining the stage, the absolute risk (PD) associated with an asset is not important. The important thing is the change in risk between initial recognition and the current reporting period. Each organisation determines their own definition of what constitutes a "significant increase" in relation to their portfolio.

A key factor is that moving to Stage 2 does not mean that an account is on its way to Stage 3, only that the risk of default has grown significantly. For example, if an asset's probability of default has increased from 0.1% to 1% then that is probably significant and the account should move to Stage 2, but there is still a 99%chance that it won't default and end up in Stage 3.

Once an account is deemed to be impaired, then it moves to Stage 3. Under IFRS9, an organisation's definition of impairment and default can be different in theory, but in practice almost every organisation aligns their impairment and default definitions, ie, they are the identical. Each organisation has their own definition of default, but the core definition is normally taken to include accounts 3+ months in contractual arrears, bankruptcy and certain types of forbearance that result in a significant reduction in the contractual cash flows[19].

7.1.3 Forward looking requirements under different economic scenarios

The IFRS9 standard requires organisations to incorporate a forward-looking view into their ECL calculations. In practice, this means calculating the ECL under different economic scenarios. For example, a downturn scenario might be where unemployment and inflation rise, and house prices fall over the next 3-5 years before recovering. Each scenario will have a different impact on the values of PD, EAD and LGD used to estimate future ECLs. For example, PDs would be expected to increase in a downturn scenario and decrease in an upturn scenario.

Organisations will typically consider somewhere between 3 and 7 economic scenarios, with associated probabilities of each scenarios occurring[20]. The ECL is then calculated for each scenario, and then combined to provide a single weighted average ECL value for each loan.

Whilst this type of scenario planning is a mandatory part of ECL under the IFRS9 standard, it is considered general good practice outside of the standard and given the cycle of volatility in recent times to be regularly assessing a range of different scenarios that may create economic instability and crisis and have an impact on expected credit losses.

Full details of the IFRS9 standard can be found here. (Section 5.5 Impairments – Recognition of expected credit losses)

[19] ie, a default definition that aligns with the Basel Capital Requirements as regulated by the PRA in the UK.
[20] The sum of the scenario probabilities should always add up to 1.0

7.2 Appendix B: glossary of terms used in this document

Term	Description
Asset Liability Committee (ALCO)	ALCO is the primary governance committee of a bank, tasked with the maintenance of the bank's balance sheet and general accounts. One of the functions of ALCO is approving the provisions allocated by the bank. Smaller commercial organisations and credit unions may absorb the duties of ALCO within Board meetings or relevant Board sub-committees.
Financial Reporting Council (FRC)	The body that interprets accounting requirements for UK businesses. The FRC produce several accounting standards that describe how UK companies should calculate their financial position and report this in their published accounts
Financial Reporting Standards (FRS)	The set of accounting standards, produced by the FRC. FRS102 contains details of provision calculations. In practice, provision under FRS102 for consumer credit and personal lending is identical to provision calculation under IAS39
IAS39	An older International Accounting standard used for calculating provisions under an "Incurred loss model" This means that provision is only calculated where there is some indicator that loss is likely to occur. For example, when a customer defaults on their loan repayments
IFRS9	The international accounting standard used by all large lenders to calculate their provisions. The calculation of provision under IFRS9 is relatively complex compared to FRS/IAS standards. Therefore, it is not widely adopted by smaller lenders due to the resource requirements of implementation
Impairment	A loan is said to be impaired if there is evidence of increased risk

Term	Description
	that the loan will not be repaid. The most obvious indicator of impairment on a loan is when the loan enters arrears due to non-payment, by there are a range of additional indicators that may indicate potential non-payment and hence impairment
Initial Recognition	Initial recognition refers to when a loan first appeared on the balance sheet. This is usually when a new loan is granted and added to a lender's portfolio. However, it can also refer to other ways in which a loan can be added to a portfolio, such as through the purchase of a loan book from another lender, or when an existing loan is consolidated or replaced by a new loan
Net Present Value (NPV)	A method of calculating how much future revenues should be accounted for in the present, taking into account the time value of money. For loans, this typically, this involves discounting future income based on the interest rate charged on the loan. The higher the interest rate the less future revenues are worth today
Provision (Impairment charge)	An amount "put aside" to cover a loss event that has not yet occurred but may happen in the future
Prudential Regulatory Authority (PRA)	The PRA is a part of the Bank of England and is regulatory body responsible for ensuring the soundness of the UK financial system. For example, ensuring that companies hold enough capital reserves and have sufficient liquidity to remain solvent
Reporting period	The frequency with which accounting figures are updated. This is usually monthly, but could be four-weekly, quarterly or another period