

# *Specialised lending*

Renewed interest in  
'slotting' across Pillar 1  
and Pillar 2 – a *UK*  
*focus*

August 2019



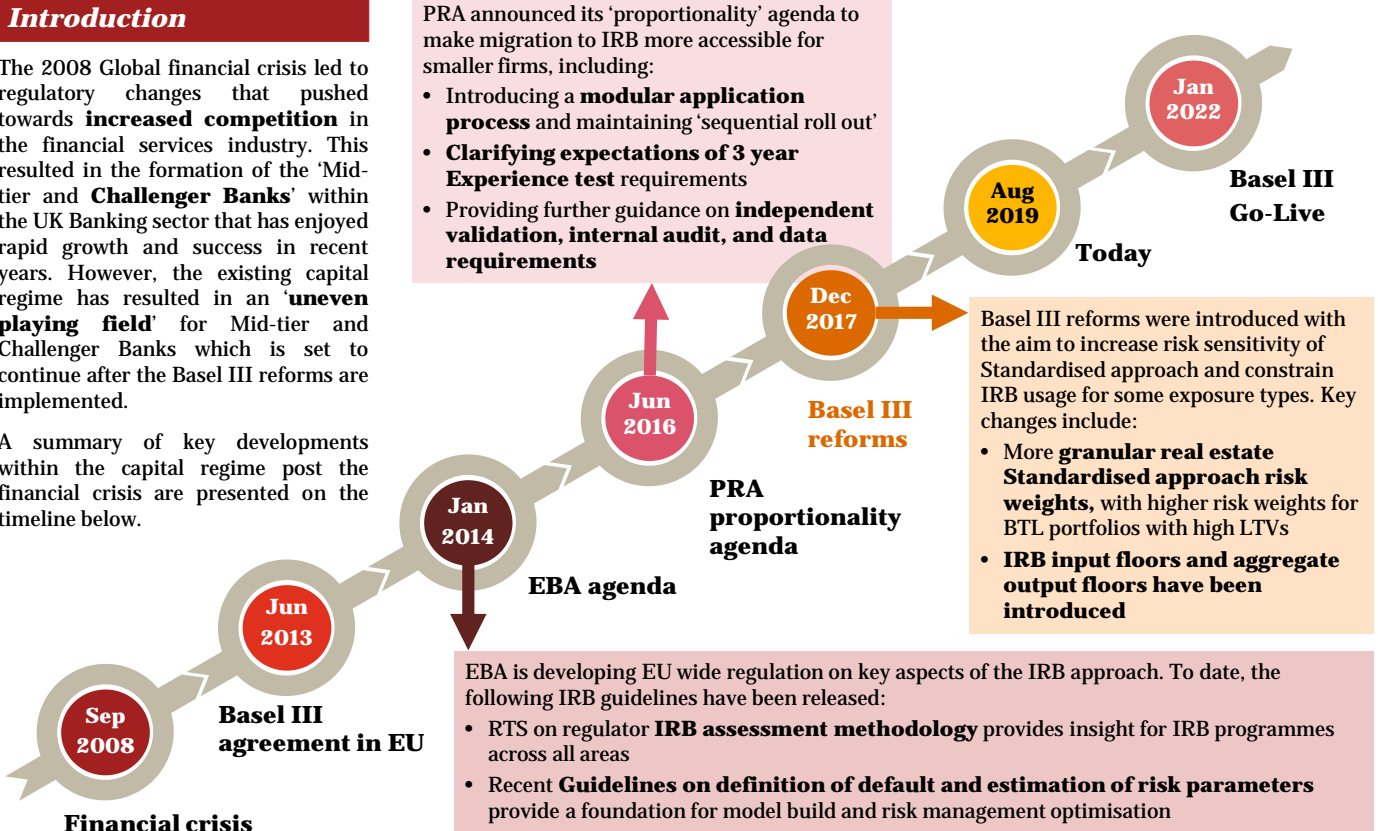
# UK Challenger Banks in the evolving regulatory landscape

## Time to make the IRB journey?

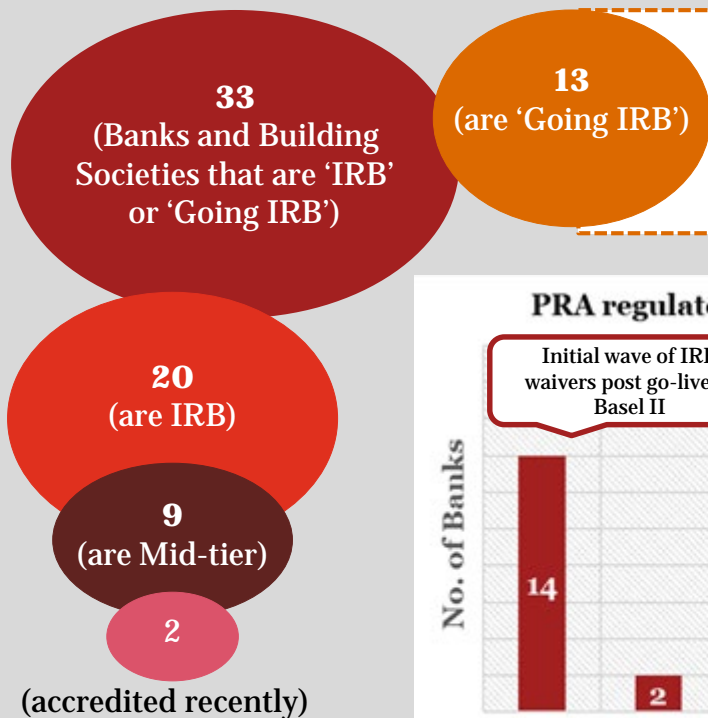
### Introduction

The 2008 Global financial crisis led to regulatory changes that pushed towards **increased competition** in the financial services industry. This resulted in the formation of the 'Mid-tier and **Challenger Banks**' within the UK Banking sector that has enjoyed rapid growth and success in recent years. However, the existing capital regime has resulted in an **'uneven playing field'** for Mid-tier and Challenger Banks which is set to continue after the Basel III reforms are implemented.

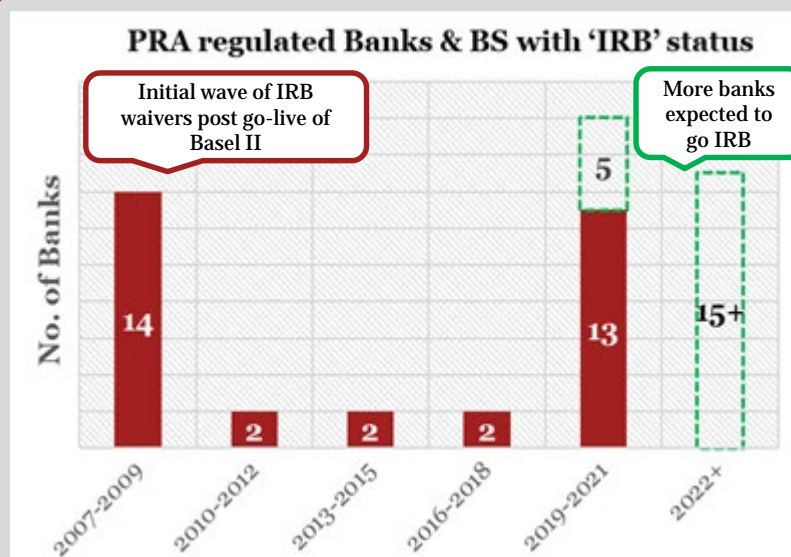
A summary of key developments within the capital regime post the financial crisis are presented on the timeline below.



## Current IRB Landscape of PRA regulated Banks and Building Societies



- Significant moves are being made **across the mid-tier (or 'challenger') Banks and Building Societies market** as firms look to take on the journey to IRB accreditation
- There is a **particular concentration around lenders with significant mortgages and BTL portfolios**, driven by the expected increase in Standardised risk weights due to the Basel III reforms. Real estate 'specialised lending' is also becoming a focus



Typical features of Banks and BS 'Going IRB'	
Total Credit exposures	£1 bn - £30 bn
Total Credit Risk-weighted Assets (RWAs)	£0.15 bn - £1 bn
Proportion of Immovable Property (IP) RWAs	35% - 100%

# Developing specialised lending slotting approaches

## Renewed interest across Pillar 1 and Pillar 2

### Introduction

As part of the wider EBA agenda to reduce RWA variability, the CRR mandated the EBA to develop regulatory technical standards (RTS) to specify the key factors and sub-factors, and the interaction of these sub-factors, when firms develop and enhance their 'slotting approaches' for specialised lending.

Specialised lending has a number of asset classes across project finance, real estate, object finance and commodity finance.

The CRR allows 'slotting approaches' to be used for these asset classes where firms are unable to build reliable and compliant models owing to the scarcity of default information. Firms should only have a single slotting approach for each asset class. Expert judgement forms a fundamental role in developing slotting approaches with strong justification required.

Development and Property Finance type products, for example, typically fall into the specialised lending category and would be captured under the 'real estate' asset class.

**IRB firms, and IRB aspirant firms,** will need to fully meet the CRR, EBA RTS and PRA SS11/13 requirements for specialised lending slotting approaches for Pillar 1 purposes. Such firms are also adopting these approaches for Pillar 2A, stress testing and ICAAP purposes.

Similarly, **Standardised firms** are also moving toward developing slotting approaches for ICAAP and SREP purposes to ensure more appropriate risk differentiation and impact is considered when assessing capital demand requirements. PRA has increased its focus on assessing slotting as part of its SREP process – developing more robust slotting approaches is key.

### Mechanics of slotting approaches

Firms are updating their exposure classification policies to ensure specialised lending exposures are defined. To support this, data collection, model governance and systems are being enhanced, along with account management activities and reporting.

Where insufficient data is available, firms are considering all 5 core factors defined by the EBA (e.g. financial strength of the borrower or sponsor) when developing slotting approaches. A significant focus has been given to the '**real estate**' asset class with firms also considering all 17 EBA sub-factors.

Based on the weightings given to each sub-factor and the quality of exposure, each exposure is given a slotting Category between 1 and 5, with 1 being the highest quality and 5 being default. Firms also leverage internal risk management practices, such as watchlists, to perform slotting approach overrides where necessary.

A risk weight (RW) is provided by regulation based on slotting Category and residual maturity. Further, an expected loss (EL) % is also provided by Category which is used when assessing the impact of provisions and any capital adjustments.

Regulatory category	Remaining maturity	RW %	EL %
Cat 1	Strong < 2.5 years	50%	0.0%
Cat 1	Strong >= 2.5 years	70%	0.4%
Cat 2	Good < 2.5 years	70%	0.4%
Cat 2	Good >= 2.5 years	90%	0.8%
Cat 3	Satisfactory All exposures	115%	2.8%
Cat 4	Weak All exposures	250%	8.0%
Cat 5	Default All exposures	n/a	50.0%

## Slotting – a UK perspective from latest Pillar 3

**c.70%**

**Average Risk Weight %** observed for current IRB firms using approved slotting approaches. Compare this to 150% RW under existing Standardised approach. The full benefit will likely be impacted by Basel III floors

**c.2%**

**Average Expected Loss %** observed for current IRB firms. Compare this to existing IFRS 9 provisions to consider further impact on CET 1 and Pillar 2A add-ons

By adopting real estate slotting approaches, Standardised firms are likely to see significant Pillar 1 benefits migrating to IRB. All firms would benefit from enhancing specialised lending approaches for Pillar 2 purposes to promote a more robust and risk sensitive approach to Pillar 2A, stress testing and SREP

**c.50%**

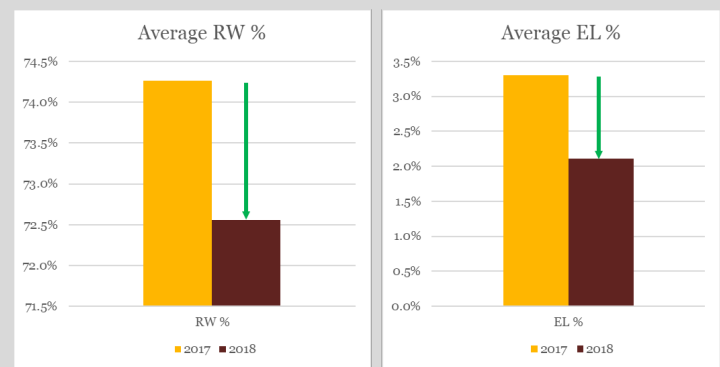
**Average Exposure % in Category 1** observed for current IRB firms. A further c.40% is typically found in Category 2, with <10% found in Categories 3 and 4. However, significant exposure profile variation exists

**c.45%**

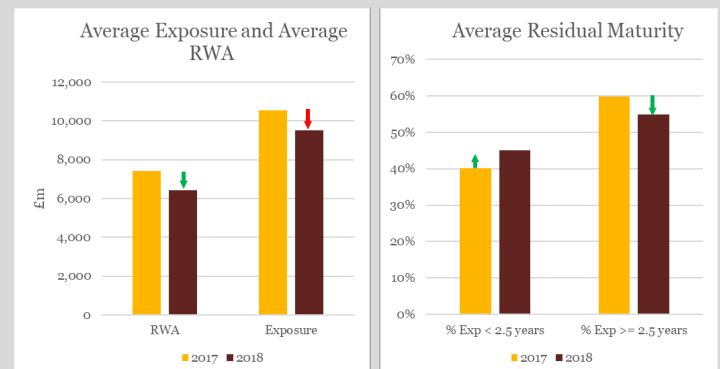
**Average Exposure % with maturity less than 2.5 years** observed for current IRB. However, we note IRB aspirant peers have higher % of short term assets. Such exposures in Category 1 and 2 receive the lowest RW %

Firms can look to optimise the Pillar 1 and Pillar 2 impacts by amending risk appetite, quality of book and maturity profile of exposures. Existing IRB firms have significant portions of their book in the highest quality Category with short residual maturity benefiting from the lowest RW % available

### Year on year trends show a reduction in both RW% and EL%



### Book size has fallen year on year with a shift to shorter terms

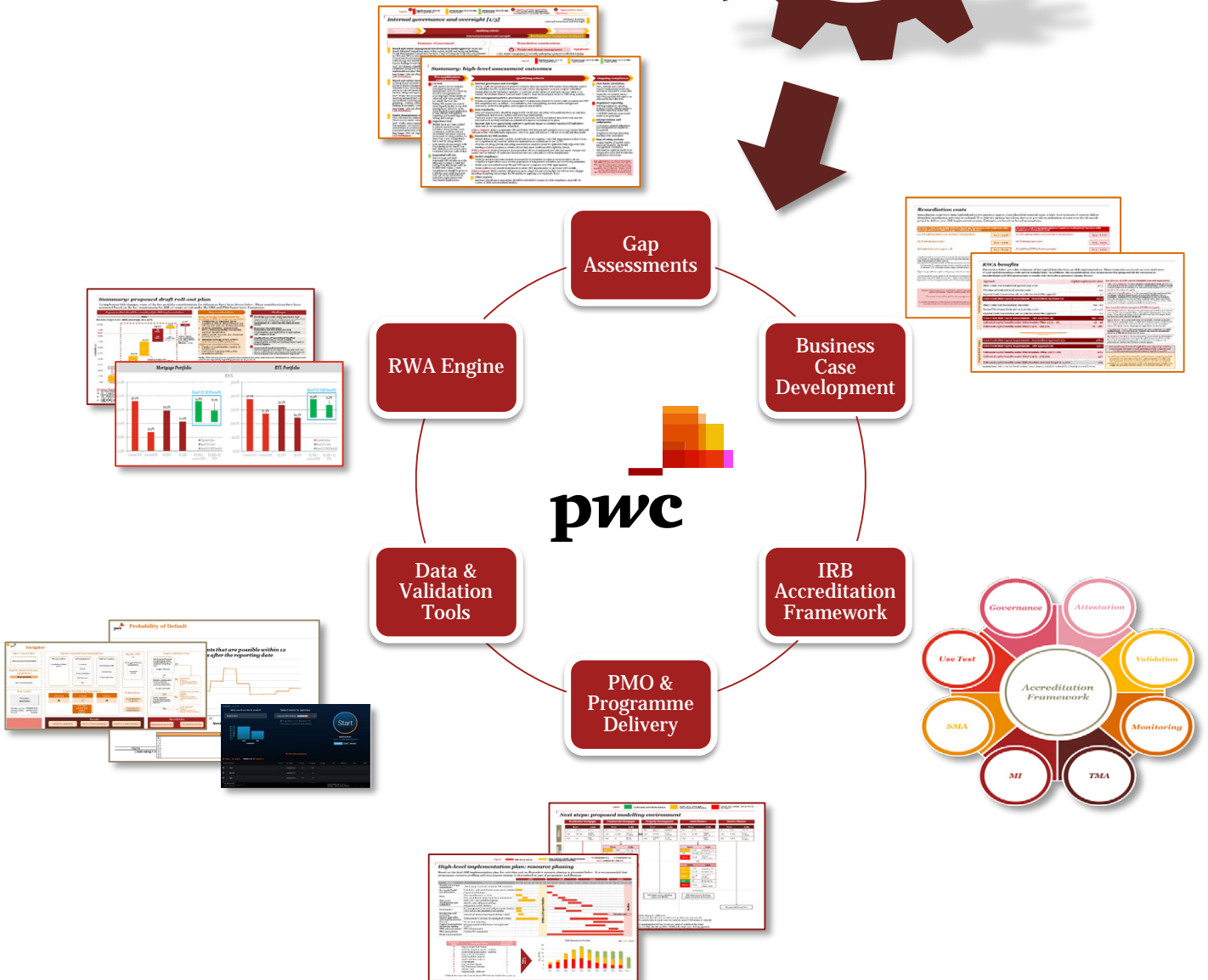


Note: key driver of UK slotting analysis is the real estate asset class

# PwC enablers and tools to support you

## How we can help – enablers and tools

PwC has developed a suite of enablers and tools that can be used to support you in the end to end implementation of regulatory products (including specialised lending and slotting approaches), ensuring compliance with the expected regulatory requirements.



This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

© 2019 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see [www.pwc.com/structure](http://www.pwc.com/structure) for further details.

181002-185428-HZ-OS

# Contacts



## ***Manuele Iorio***

Director

T: +44 (0) 7718 980 479

E: [manuel.iorio@pwc.com](mailto:manuel.iorio@pwc.com)

---



## ***Jason Benton***

Associate Director

T: +44 (0) 7894 231 008

E: [jason.benton@pwc.com](mailto:jason.benton@pwc.com)

---



## ***Hana Zaman***

Manager

T: +44 (0) 7753 459 159

E: [hana.a.zaman@pwc.com](mailto:hana.a.zaman@pwc.com)

---



## ***James Mankelow***

Manager

T: +44 (0) 7802 660 143

E: [james.d.mankelow@pwc.com](mailto:james.d.mankelow@pwc.com)

---

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

© 2019 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see [www.pwc.com/structure](http://www.pwc.com/structure) for further details.

181002-185428-HZ-OS