Credit Benchmark

EC Capital Proposals: Low Profile, High Impact

November 2021

Key points:

- **Most EU corporates and funds are unrated by the traditional credit rating agencies ("CRAs")**
- **The output floor is delayed until 2025 so the capital impact is postponed**
- **The risk weighting for unrated investment grade corporates risk will drop from 100% to 65% during the transition period which will cause little change in weighted average RWA.**
- **There will be a negative impact on funds being treated as equivalent to unrated corporates, with a large increase in weighted average RWA.**
- **The proposals may be a boost for the ECAI business model**
- **SFT minimum haircuts are delayed – money market liquidity maintained pending review**

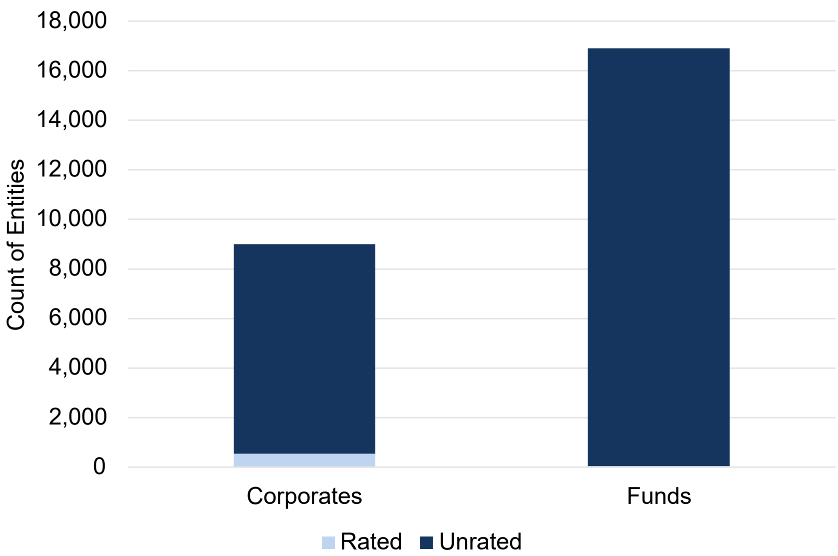
European Commission proposals published in October 2021 have significant implications for credit risk and the "aggregate output floor". This has been a contentious area since the Basel guidelines were updated in 2017, with market participants warning that the higher risk weights for high quality unrated corporates – which crucially includes funds - will lead to a dramatic increase in bank capital requirements and a reduction in lending.

For banks using an internal ratings-based ("IRB") approach, the aggregate output floor requires calculated risk weighted assets ("RWA") to be greater than or equal to 72.5% of the "standardised" RWA (i.e. as calculated by the Basel standardised framework).

Under the pending Basel rules, high quality credits with no external rating will be assigned a risk weight of 100% - a significant jump from the typical range of PD/LGD model-based estimates previously. Currently, the vast majority of corporates along with nearly all of the tens of thousands of high quality funds do not have an external rating; in part due to the cost of retaining a traditional credit rating agency ("CRA") rating.

Figure 1 shows the proportion of 26,000 EU Corporates and Funds[1] that have a rating from global banks but no rating from any of the three major CRAs.

Figure 1: Banks' coverage and CRA ratings for EU Corporates and Financials



1 Provided by 11 global banks with significant exposure to EU entities (defined as 700 and more entities). The universe breaks down to 34% traditional Corporates and 66% Funds.

This shows that only 6% of corporates and 0.2% of funds have CRA ratings.

Commission estimates suggest that the minimum required capital for unrated corporates would increase by 1.5 percentage points. Increased risk weights for unrated firms and funds are likely to systemically increase funding costs – with knock-on effects for the real economy and capital market liquidity.

To mitigate this – albeit temporarily - the Commission has made the following proposals:

1. **Transition period start date delayed to 2025**

The Commission has proposed that the five-year transitional arrangement to implement the Basel guidelines will now commence from 2025 instead of 2023 as originally planned.

2. **Transitional arrangements for unrated corporates introduced**

The Commission has recommended a transitional arrangement for unrated corporate exposures: unrated high-quality corporates (probability of default of less or equal to 0.5% or 50bp, consistent with an investment grade rating) will have a "preferential" risk weight of 65%.

3. **Increase in coverage of unrated corporates by public or private ECAIs**

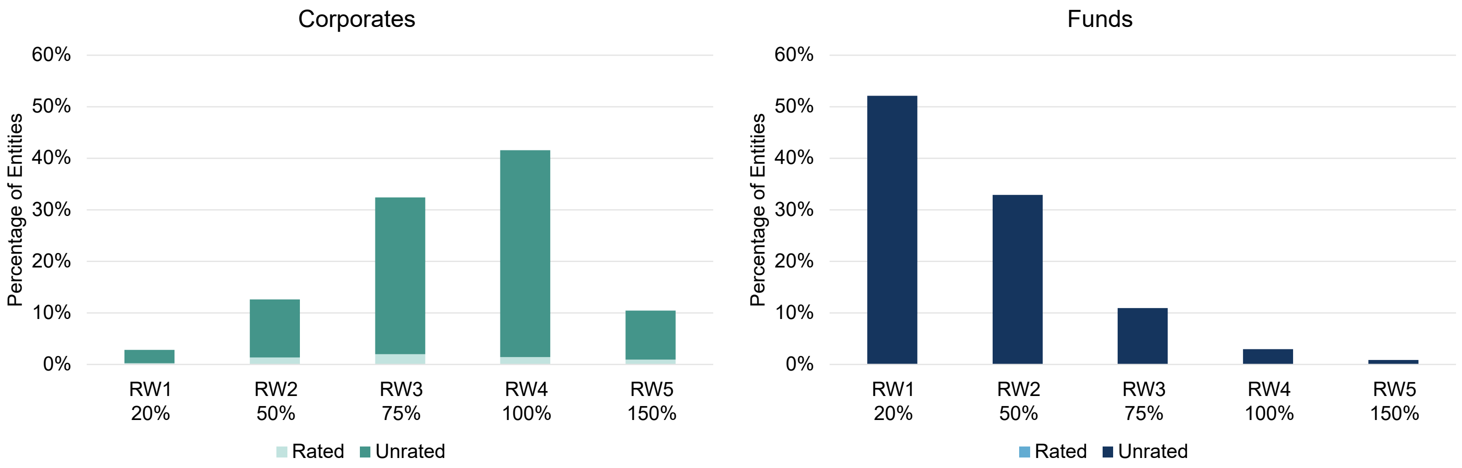
The Commission has made it clear that the long-term solution for the Basel rules must be to increase credit rating coverage, and if this cannot be achieved by private initiatives, then public sector initiatives should be established.

4. **Securities Financing Transactions (SFTs)**

The Financial Stability Board recommended to introduce minimum collateral haircuts for some non-centrally cleared SFTs traded between banks and non-banks to address the risk of excessive leverage outside the banking sector. The Commission has proposed to postpone the introduction of the minimum haircut floors until the EBA and ESMA jointly report to the Commission.

While these proposals mitigate the output floor impact on exposures to traditional corporate entities, the impact on fund exposures could be significant. Figure 2 compares the position for corporates and funds.

Figure 2: Distribution of credit risk across the five risk-weight categories for Corporates and Funds



This shows that there are just very few Corporates in categories RW1 (20% risk-weight) and RW2 (50% risk-weight), and the distribution peaks in RW4 (100% risk-weight). This means that once all Corporates have an external rating, their average (equal-exposure) risk-weight will be around 85%. The transitional simplified approach using just 65% for investment grade entities (RW1 to RW3) and 100% for others results in an almost identical average risk-weight of 83%.

However, the Funds distribution peaks in RW1 (20% risk-weight) and only 4% Funds have a rating worse than RW3 (the Funds universe also includes some Hedge Funds, which have higher credit risk and usually rate as high yield). This means that transitional approach overestimates the average risk-weight compared to the five-categories approach for rated entities. If all the Funds were rated, their average risk weight would be 40%, while the transitional approach results in 66% average risk-weight.

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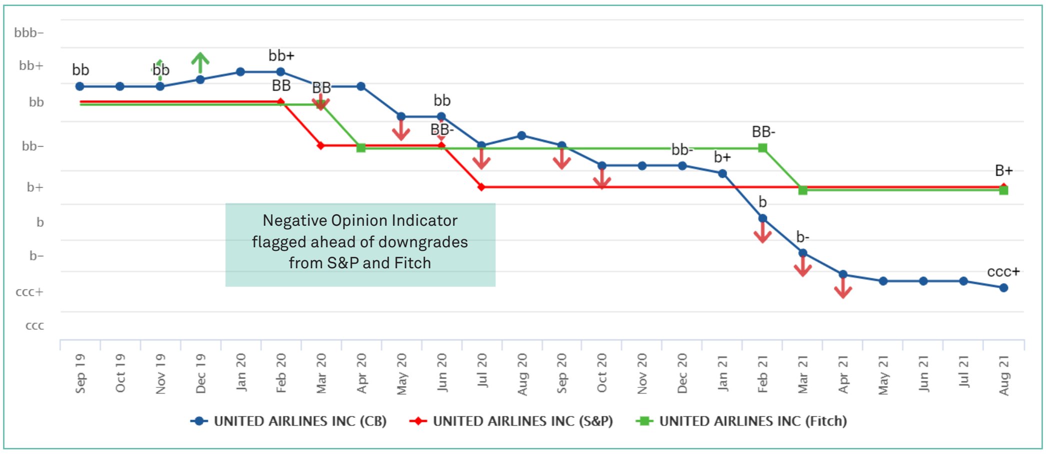

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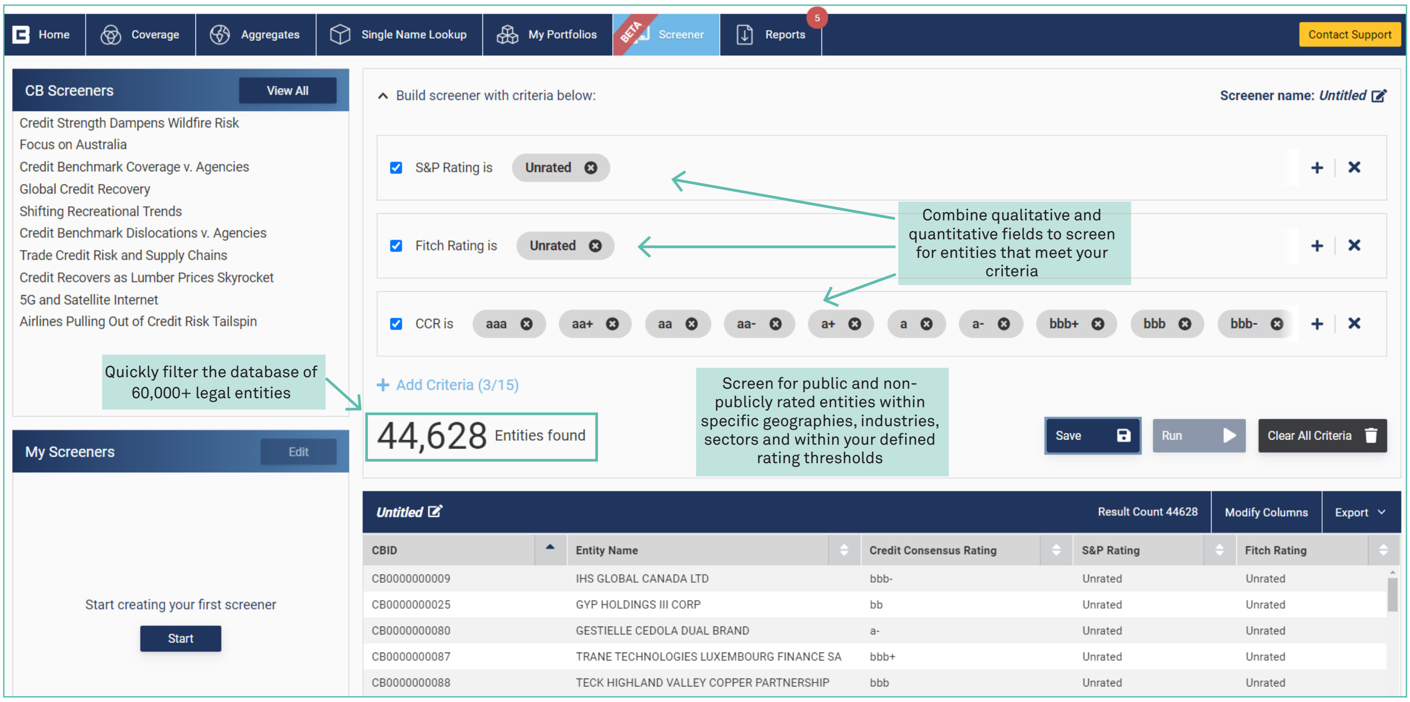
Credit Benchmark Web App: Entity-Level Data Sample



Credit Benchmark Web App: Data Screen Sample

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