The Impact of the Regulatory Landscape on Credit Risk Assessment

S&P Credit Solutions To Successfully Meet The Regulatory Requests

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Basel 3.1: Strengthening the Global Banking System through Enhanced Risk-Weighted Assets

The major weaknesses of IRB approach identified by Basel:

① Lack of robustness for certain asset classes

② Excessive complexity

③ Lack of comparability
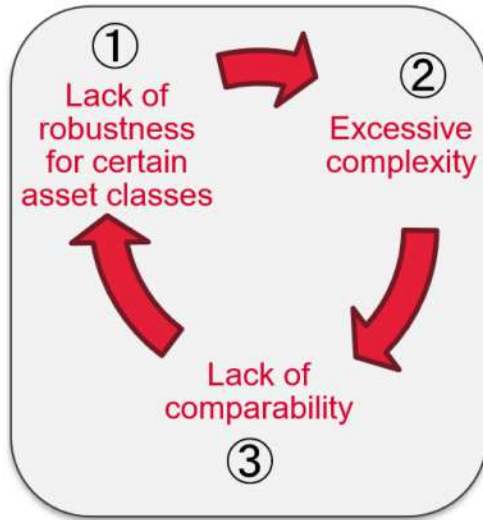
S&P models against market shortcomings

① **Robustness of S&P models**

- Various qualitative risk drivers in addition to financial data aiming at increasing robustness of the model
- Robust calibration based on proprietary S&P's global default database dating back to 1981
- Subject-matter credit expertise for asset classes where statistical modelling is not possible
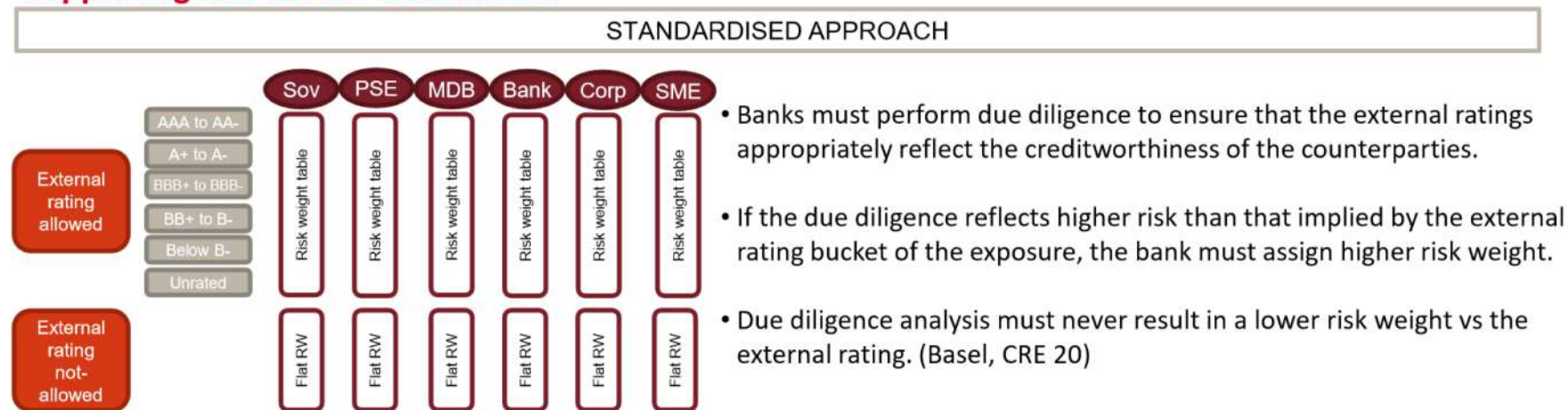
② **Complexity of S&P models**

- Shadow-rating methodology which reduces complexity
- Simple, open-form and technology agnostic – easy to implement in client internal system.

③ **Comparability of S&P models**

- Consistent rules on how to assess credit rating
- Comparability of risk drivers with S&P rated universe

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Basel 3.1: Standardized approach

Supporting role of S&P Scorecards

STANDARDISED APPROACH

Sov | PSE | MDB | Bank | Corp | SME

External rating allowed
- AAA to AA-
- A+ to A-
- BBB+ to BBB-
- BB+ to B-
- Below B-
- Unrated

Risk weight table (×6: Sov, PSE, MDB, Bank, Corp, SME)

External rating not-allowed

Flat RW (×6: Sov, PSE, MDB, Bank, Corp, SME)

- Banks must perform due diligence to ensure that the external ratings appropriately reflect the creditworthiness of the counterparties.

- If the due diligence reflects higher risk than that implied by the external rating bucket of the exposure, the bank must assign higher risk weight.

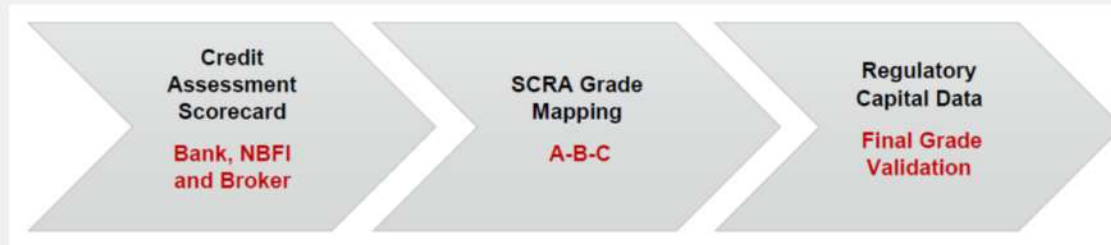- Due diligence analysis must never result in a lower risk weight vs the external rating. (Basel, CRE 20)

❑ S&P Scorecards may play crucial role in due diligence process within Standardised Approach.

❑ Even if the banks use the external ratings they are obliged to evidence that the ratings are sufficiently conservative for the counterparties they are assessing.

❑ Using regulatory risk weights does not replace the need of having an independent risk assessment for internal management and reporting purposes.

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Basel 3.1: Standardised Credit Risk Assessment Approach (SCRA)

- In jurisdictions that do not allow the use of external ratings or for unrated exposures under ECRA.

- Under SCRA, banks have to classify **bank exposures** into buckets (i.e., A, B and C) and assign the corresponding risk weights.

- Banks **must perform due diligence** to ensure that the 'buckets' assigned are **appropriate and conservative**.

- To ensure **consistency and comparability** of banks portfolios under ECRA and SCRA, banks could use internal credit assessment to assign risk buckets independently and transparently.

S&P SCRA Work Flow

Credit Assessment Scorecard	SCRA Grade Mapping	Regulatory Capital Data
Bank, NBFI and Broker	A-B-C	Final Grade Validation

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What is changing with SCRA in Basel III?

Potential impact on the RWA and capital for exposures to Banks and Securities Firms

Basel II SA Two Options with External Ratings

Option 1

Credit assessment of Sovereign	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk weight under Option 1	20%	50%	100%	100%	150%	100%

Option 2

Credit assessment of Banks	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk weight under Option 2	20%	50%	50%	100%	150%	50%

Basel III SA

RATED EXPOSURE - ECRA

Risk weight table for bank exposures

External Credit Risk Assessment Approach — Table 6

External rating of counterparty	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-
"Base" risk weight	20%	30%	50%	100%	150%
Risk weight for short-term exposures	20%	20%	20%	50%	150%

UNRATED EXPOSURE - SCRA

Risk weight table for bank exposures

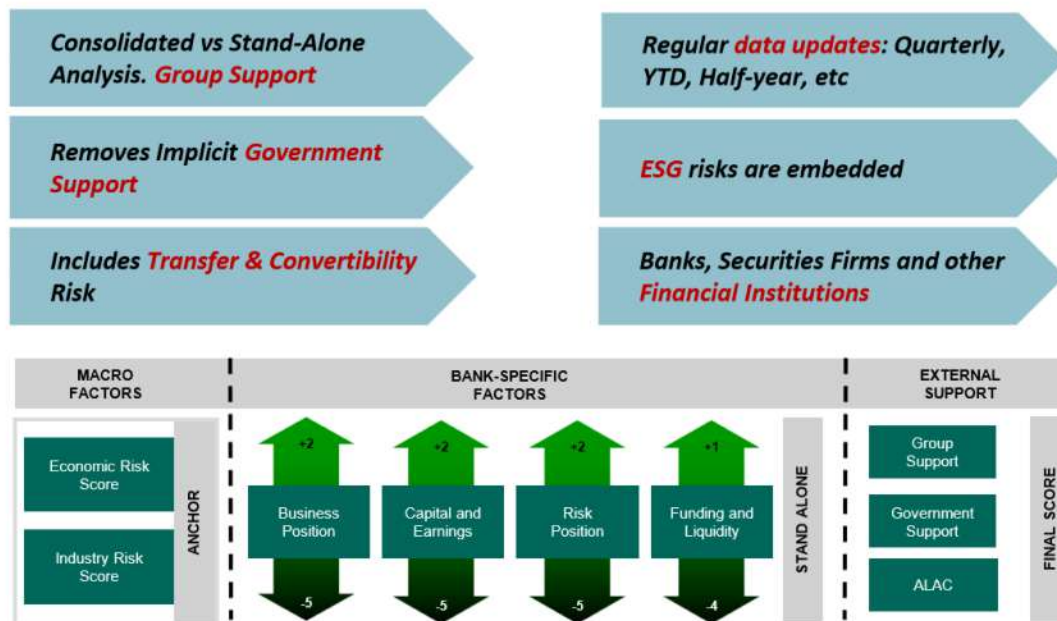Standardised Credit Risk Assessment Approach — Table 7

Credit risk assessment of counterparty	Grade A	Grade B	Grade C
"Base" risk weight	40%	75%	150%
Risk weight for short-term exposures	20%	50%	150%

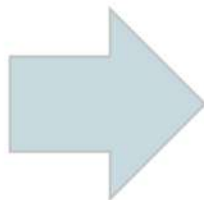# Step 1: Determining the cut off points based on "capacity"

How Scorecard is tackling some of the key hurdles of SCRA requirements:

Consolidated vs Stand-Alone analysis. Group Support	**Regular data updates: Quarterly, YTD, Half-year, etc**
Removes Implicit Government Support	**ESG risks are embedded**
Includes Transfer & Convertibility Risk	**Banks, Securities Firms and other Financial Institutions**

MACRO FACTORS		BANK-SPECIFIC FACTORS					EXTERNAL SUPPORT	
Economic Risk Score	**ANCHOR**	Business Position (+2 / -5)	Capital and Earnings (+2 / -5)	Risk Position (+2 / -5)	Funding and Liquidity (+1 / -4)	**STAND ALONE**	Group Support	**FINAL SCORE**
Industry Risk Score							Government Support	
							ALAC	

Source: S&P Global Market Intelligence, for illustrative purposes only.

Step 2: Output from Scorecard to inform grades

Numeric scale	Letter-grade scale
1	aaa
1.5	aa+
2	aa
2.5	aa–
3	a+
3.5	a
4	a–
4.5	bbb+
5	bbb
5.5	bbb–
6	bb+
6.5	bb
7	bb–
7.5	b+
8	b
8.5	b–
9	ccc+
9.5	ccc
10	ccc–

A Counterparty bank has **adequate** capacity to meet their financial commitments **for the projected life of the assets** or exposures and **irrespective of the economic cycles** and business conditions....

B Counterparty bank is subject to **substantial credit risk**, such as repayment capacities are **dependent** on stable or favourable economic or business conditions.

C Counterparty bank has material default risks and limited margins of safety. For these counterparties, **adverse business, financial, or economic conditions are very likely to lead, or have led, to an inability to meet their financial commitments.**

Step 3: Data Search - Bank' regulatory capital vs minimum requirements and buffers
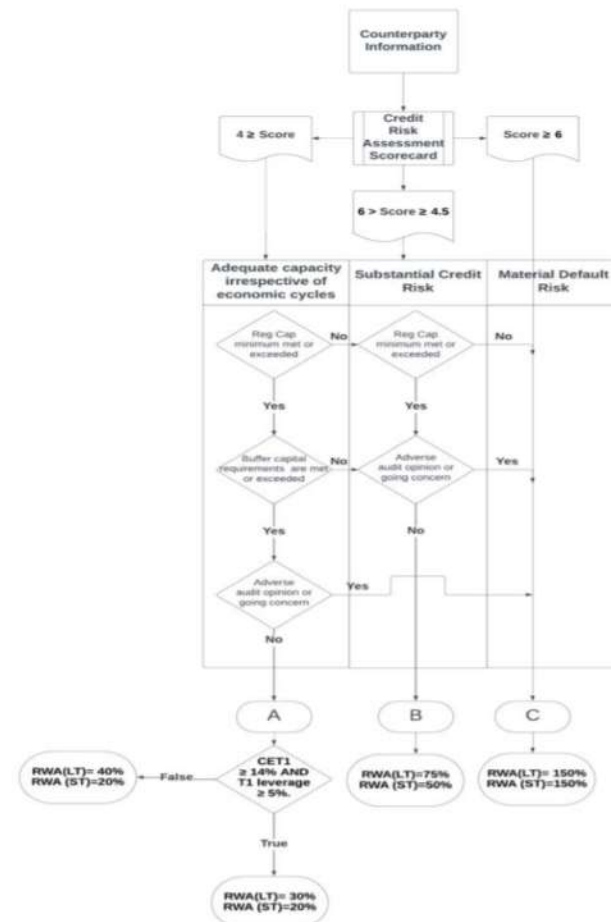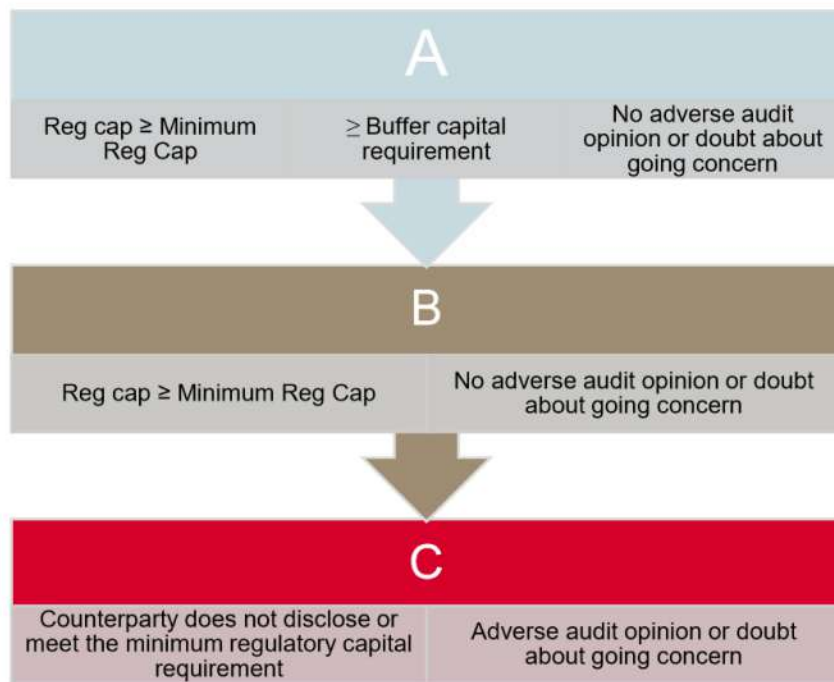
- Under which jurisdiction is the bank incorporated?
- Who is the national supervisor?
- Is the minimum regulatory capital requirement (%) publicly disclosed?
- What is the minimum regulatory capital requirement?
- Does the bank meet minimum capital requirement?
- Is the buffer capital requirement (%) publicly disclosed?
- What is the buffer capital requirement?
- Does the bank meet buffer capital requirements?

Extensive Basel III/IV Reporting Resources available in S&P Capital IQ Pro. Sample below:

Auditor Opinion	Other Risk Buffer (%)
Pillar 1 Minimum Requirement (%)	Total CET1 Requirement (%)
Pillar 2 Minimum Requirement (%)	Total Tier 1 Requirement (%)
Capital Conservation Buffer (%)	Total Capital Requirement (%)
Counter Cyclical Buffer (%)	Minimum Basel III Leverage (%)
Systemic Risk Buffer (%)	Minimum TLAC Requirement (%)
Leverage Ratio %	Tier 2 ratio (%)

Step 4: Confirm regulatory capital standing

A

| Reg cap ≥ Minimum Reg Cap | ≥ Buffer capital requirement | No adverse audit opinion or doubt about going concern |

B

| Reg cap ≥ Minimum Reg Cap | No adverse audit opinion or doubt about going concern |

C

| Counterparty does not disclose or meet the minimum regulatory capital requirement | Adverse audit opinion or doubt about going concern |

Counterparty Information

Credit Risk Assessment Scorecard

4 ≥ Score

Score ≥ 6

6 > Score ≥ 4.5

| Adequate capacity irrespective of economic cycles | Substantial credit Risk | Material Default Risk |

Reg Cap minimum met or exceeded — No
Reg Cap minimum met or exceeded — No

Yes
Yes

Buffer capital requirements are met or exceeded — No
Adverse audit opinion or going concern — Yes

Yes
No

Adverse audit opinion or going concern — Yes

No

A   B   C

RWA(LT)= 40%
RWA (ST)=20% ← False

CET1 ≥ 14% AND T1 leverage ≥ 5%.

RWA(LT)=75%
RWA (ST)=50%

RWA(LT)= 150%
RWA (ST)=150%

True

RWA(LT)= 30%
RWA (ST)=20%

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Basel 3.1: Slotting approach - Specialised lending

Supporting role of S&P Scorecards

Slotting models are applied to special lending exposures (Project Finance, Object Finance, etc). Banks can use internal models or regulatory slotting models for those asset classes. <u>If they opt for regulatory slotting models, they will need to allocate exposures to one of 5 risk category using the internal rating grades.</u>

	Strong	Good	Satisfactory	Weak	Default
Risk category	BBB- or better	BB+ or BB	BB- or B+	B to C-	Not applicable
Risk weight	X%	X%	X%	X%	X%

S&P Scorecards treat similar risk drivers as the supervisory criteria. They facilitate the mapping process to individual slots.

- Although banks are expected to map their internal ratings to the supervisory categories for **specialised lending** using the slotting criteria, each supervisory category broadly corresponds to a range of external credit assessments as outlined below. (Basel, CRE 20)
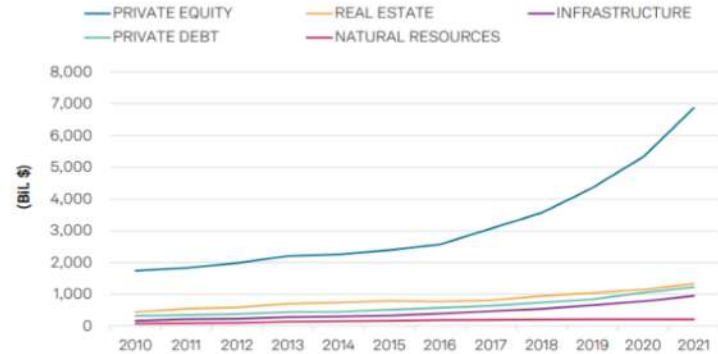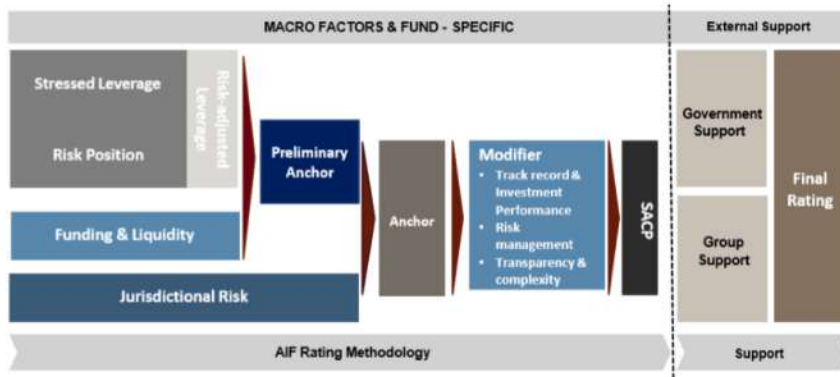- Banks must demonstrate that their mapping process has resulted in an alignment of grades.

S&P scorecards provide rating categories which are well aligned with the S&P Global Ratings and the methodology itself covers all the risk areas from the regulatory table (on the right) and satisfy the regulatory requirement.

Allocation mechanism	Strong	Good	Satisfactory	Weak	Default
Financial strength					
Political and legal environment		Definitions and sub-categories provided in the regulation			
Transaction characteristic					
Strength of sponsor					
Security package					

Regulatory Focus: Alternative Investment Funds (AIF)

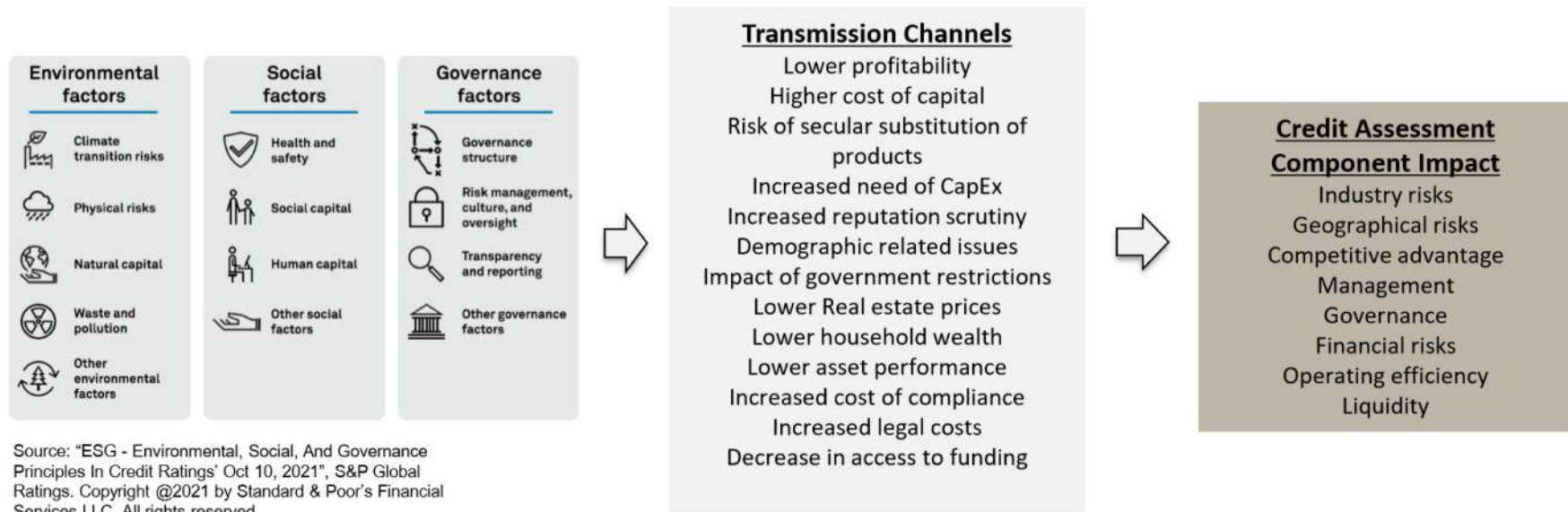*ECB calls on lenders to manage growing risk from shadow banks (Reuters, April 2025)*

- Even in the face of elevated volatility, the volume of alternative assets under management is set to grow further to $23 trillion by 2026 from approx. $10 trillion in 2019.
- According to S&P ratings, AIFs will be under pressure due to uneven valuations, slowing fundraising and higher liquidity needs. Some will likely return to debt to invest.

Legend: PRIVATE EQUITY — REAL ESTATE — INFRASTRUCTURE — PRIVATE DEBT — NATURAL RESOURCES

Source: Preqin, S&P Global Ratings.

AIF Rating Methodology diagram: MACRO FACTORS & FUND - SPECIFIC (Stressed Leverage, Risk Position, Funding & Liquidity, Jurisdictional Risk, Risk-adjusted Leverage, Preliminary Anchor, Anchor, Modifier: Track record & investment performance, Risk management, Transparency & complexity, SACP) — External Support (Government Support, Group Support, Final Rating) — Support

- In a sector where transparency and illiquid assets are a key issue, the AIF Scorecard provides an easy-to-use tool to evaluate the creditworthiness of funds and their debt instruments.

- Key measures of AIF's risks are: stressed leverage, risk position, funding and liquidity, jurisdiction, track record and performance, complexity and transparency.

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Identify ESG Credit Factors & Transmission Channels to Credit Assessments

Environmental factors	Social factors	Governance factors
Climate transition risks	Health and safety	Governance structure
Physical risks	Social capital	Risk management, culture, and oversight
Natural capital	Human capital	Transparency and reporting
Waste and pollution	Other social factors	Other governance factors
Other environmental factors		

Transmission Channels

Lower profitability
Higher cost of capital
Risk of secular substitution of products
Increased need of CapEx
Increased reputation scrutiny
Demographic related issues
Impact of government restrictions
Lower Real estate prices
Lower household wealth
Lower asset performance
Increased cost of compliance
Increased legal costs
Decrease in access to funding

Credit Assessment Component Impact

Industry risks
Geographical risks
Competitive advantage
Management
Governance
Financial risks
Operating efficiency
Liquidity

ESG in Credit Risk: Developments

Specific actions for corporate loan analytics and credit risk management

⟹ **Identify**   ⟹ **Quantify**   ⟹ **Report**
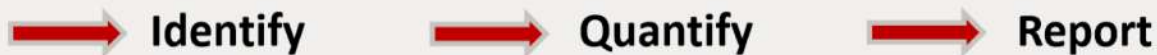
Clarify methodological approach and train credit analysts

- Define ESG relevant credit risk factors

- Introduce ESG sector materiality

- Integrate ESG more structurally and transparently in the credit assessment

Ensure consistency of definitions, data and models

- Clarify connection between credit and ESG assessments

- Shifting focus of assessments on the overall sustainability of borrowers´ business models

Enhance models, data and criteria as new evidence becomes available

- Build robust and flexible methodological framework to evolve over time

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…entirely developed, maintained and supported by us, requiring minimum client internal resources

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