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Ratings under the microscope: how ECAIs shape Banks' Capital Requirements

Authors

Luca D'Amico
Marco Bonsanto
Dirk Burdorf

Basel III was conceived in response to the weaknesses exposed by the 2008 financial crisis, with the aim of strengthening the resilience of the global banking sector. By introducing stricter capital requirements (coupled also with the EU Capital Requirements Regulation), liquidity standards, and leverage ratios, it seeks to reduce systemic risk and restore confidence in international markets.

In an increasingly globalized and complex world, characterized by exogenous risks, the calculation of capital requirements is not merely a technical exercise but it influences and supports banks in managing and mitigating these risks. The two main approaches a bank can adopt are essentially (i) the Standardised Approach (SA) and (ii) the Internal Ratings-Based (IRB) Approach.

At first glance, although these approaches are alternatives to each other, they can find in an external actor a trait d'union element that enables comparison or strengthens awareness of credit risk.

Standardised Approach

The Standardised Approach represents the most straightforward option. It relies on predefined risk weights assigned to exposures based on their segment (sovereigns, banks, corporates, retail) and, when available, external ratings. Its advantage lies in uniformity and ease of application, as it does not require model development or supervisory validation. However, this simplicity is also its main weakness: risk weights are not highly sensitive to actual risk and fail to capture portfolio-specific characteristics. A bank with solid clients but operating under this method without external ratings might end up locking in more capital than necessary, reducing competitiveness.

The IRB Approach, by contrast, is more sophisticated and rewards investment in risk management systems. It allows banks to internally estimate parameters such as Probability of Default (PD), Loss Given Default (LGD), and Exposure at Default (EAD). This approach offers greater risk sensitivity and can lower required capital, but it entails high costs, strict governance, and continuous model validation. Moreover, model variability can create distortions and hinder comparability among institutions, posing transparency and competition challenges.

Both approaches can generally benefit from publicly available ratings, which predominantly target large listed non-financial corporations, leaving the SME segment, widely regarded as the backbone of the European economy, largely uncovered. With respect to this asset class, only a limited number of rating agencies provide coverage for SMEs and mid-caps, typically

focusing on local companies within specific countries. In contrast, CRIF Ratings has issued approximately 10,000 ratings across Europe, leveraging direct access to financial data and bespoke methodologies designed to assess SMEs entities.

Having outlined these two alternative methods, it becomes necessary to introduce the second actor in this narrative—the external entity that can help achieve more efficient risk management.

Who are ECAIs and how are they useful in both approaches

The assessments provided by External Credit Assessment Institutions (ECAIs) influence the calculation of banks' capital requirements, determining the amount of capital they must set aside to cover credit risk. To qualify as an ECAI, a rating agency must demonstrate methodological rigor, independence, and transparency. These principles are enforced by the European Securities and Markets Authority (ESMA) under the Credit Rating Agency Regulation (1060/2009). Each rating must reflect the most up-to-date conditions and is subject to periodic review, at least annually.

Under the Standardised Approach, ECAIs are strategic allies. For companies with an investment-grade rating (BBB- or higher), the application of ECAI ratings leads towards significantly more favorable risk weights and therefore reduced capital requirements compared to an unrated entity. In the context of German and European case studies on SME portfolios, the application of ECAI ratings, rather than leaving companies unrated, could result in a reduction of risk-weighted assets by up to 20%.

Under IRB, ECAIs are not integral to the calculation but play an important indirect role. Banks use them as benchmarks to calibrate internal models and validate estimates. In practice, even institutions relying on internal models cannot ignore the value of external assessments.

In summary, the first approach is a "one-size-fits-all" model that becomes more flexible thanks to ECAIs; the second, while tailored, benefits from external comparison to maintain balance and transparency. Both, in different ways, find in ECAIs a reference point for reducing uncertainty and fostering stability.

Methodological Context: how Credit Rating Agency's (CRA) approach aligns with Basel III and ESMA oversight

Within this framework, ECAIs play a pivotal role: they provide external benchmarks that complement regulatory models, ensuring that risk assessments remain credible and consistent. Their integration into Basel III's architecture underscores a broader principle, financial stability depends not only on robust rules but also on reliable, independent evaluations. A CRA's structured methodology on non-financial corporates/SMEs is built on three analyti-

cal pillars: Business Risk, Financial Risk and ESG Factors. These constitute the foundational elements upon which each rating exercise is built.

The first pillar focuses on the company's operating environment and its ability to withstand competitive pressures. Industry and sector risk analysis considers structural dynamics such as supply-demand balance, regulatory frameworks and technological trends that influence long-term sustainability. Competitive positioning is assessed to determine whether the entity benefits from economies of scale, pricing power, or innovation leadership. Diversification, both geographical and across products, plays a critical role in mitigating concentration risk. CRAs also evaluate the quality and breadth of supplier and client bases to gauge dependency risks and the stability of commercial relationships.

This approach aligns with Basel III's emphasis on transparency and comparability: by systematically analyzing structural and competitive factors, CRAs ensure that ratings reflect not only current performance but also resilience under stress scenarios.

The second pillar addresses the issuer's capacity to meet obligations through internally generated cash flows and access to external funding. CRAs adopt a through-the-cycle perspective, combining historical performance with forward-looking projections under conservative assumptions. Key metrics include leverage and coverage ratios, which measure the ability to service interest obligations. Beyond ratios, the methodology examines debt maturity profiles, interest rate exposure and liquidity buffers such as unrestricted cash and committed credit lines. Adjustments for off-balance-sheet items (leases, factoring) ensure that reported figures accurately reflect underlying credit risk.

Such rigor supports ESMA's requirement for objectivity and consistency, while reinforcing Basel III's principle that risk-sensitive measures should underpin capital adequacy.

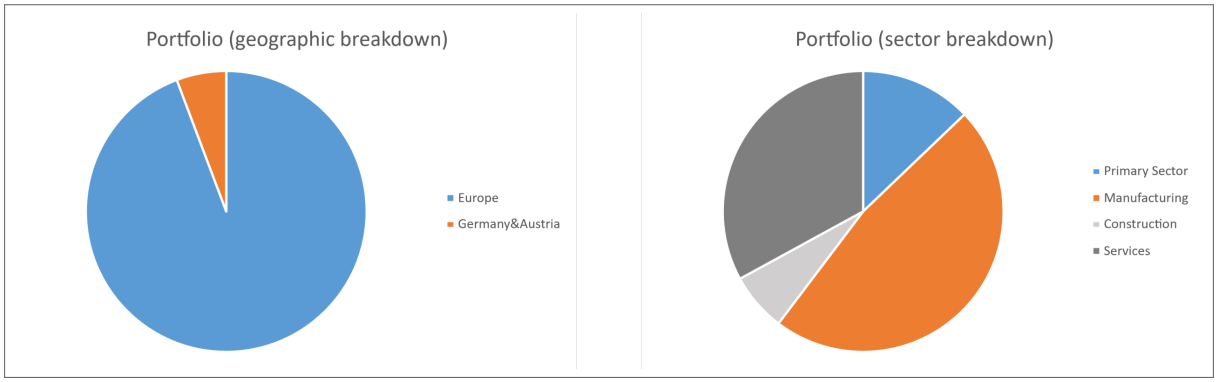
The third pillar integrates Environmental, Social, and Governance considerations when they materially affect sustainability or solvency. A robust governance framework, characterized by board independence, transparency, and sound shareholder practices, enhances rating stability. Conversely, deficiencies in governance or inadequate management of environmental and social risks may constrain ratings, particularly for investment-grade issuers. ESG analysis goes beyond compliance, assessing whether deficiencies may jeopardize operational continuity or lead to financial liabilities, such as regulatory fines or reputational damage.

This dimension reflects the growing regulatory focus on sustainability risks within the EU banking framework and complements Basel III's broader objective of safeguarding systemic stability.

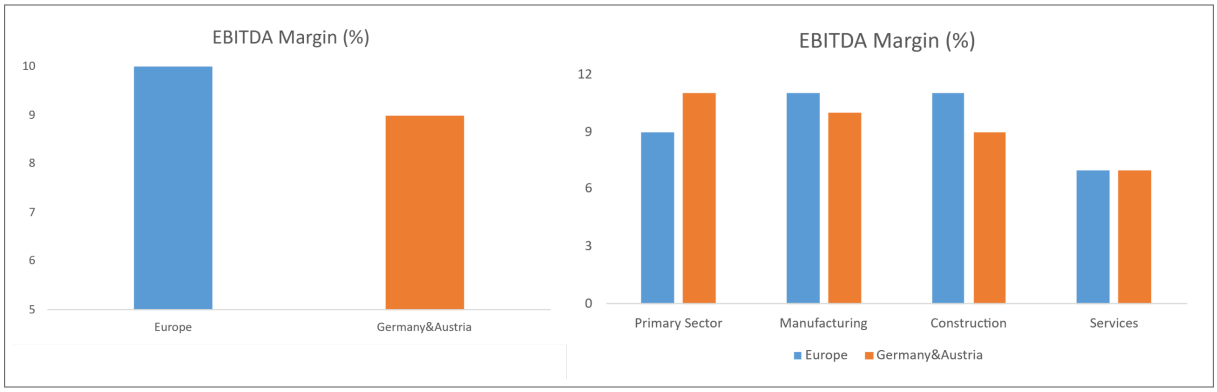
By integrating structural, financial and ESG factors, CRAs provide ratings that serve as credible inputs for risk-weight calculations under the SA and as benchmarks for internal models under IRB. This methodological robustness enhances comparability across institutions, mitigates regulatory arbitrage, and ultimately supports the integrity of Basel III's capital adequacy regime.

A comparative study of profitability and leverage across European Corporates

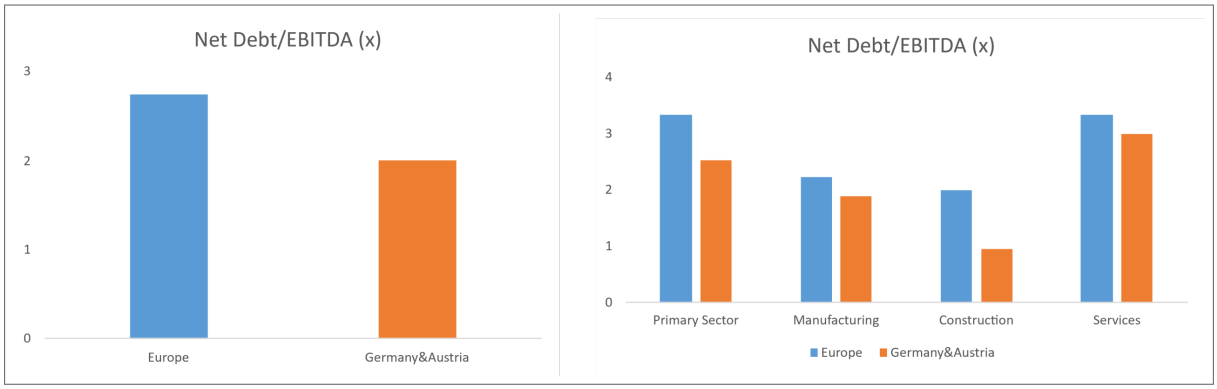
At this point, understanding the comparative performance of European corporates in light of evolving macroeconomic conditions and financial stability concerns is essential. To explore these dynamics, CRIF Ratings conducted an in-depth study on a sample of approximately 9,000 rated European companies (primarily focused on SMEs segments), of which 6% represent German and Austrian (DE-AU) companies. The objective was to assess key economic and financial indicators and identify structural differences across major sectors. The portfolio was segmented into four macro-sectors (primary sector, manufacturing, construction and services) to provide a detailed view of two critical indicators. From an economic perspective, the focus was on the EBITDA margin (Earnings Before Interest, Taxes, Depreciation and Amortization as a percentage of Revenues), while the financial dimension was captured through the Net Debt (Total short and long term financial debt net of unrestricted cash and cash equivalents) to EBITDA ratio.



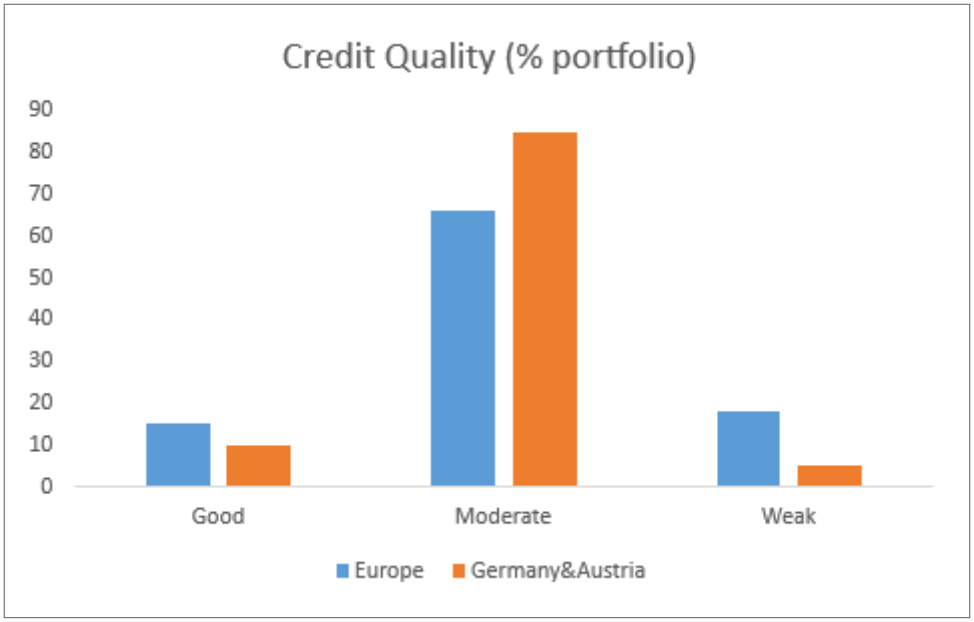
The findings reveal that DE-AU corporates exhibit, on average, a lower EBITDA margin compared to their European peers (9% versus 10%). Sectoral analysis highlights the most pronounced gaps in the **construction** (9% versus 11%) while differences in **manufacturing and services** remain marginal. By contrast, the DE-AU companies show a better profitability ratio as regards the **primary sector** (11% vs 9%).



Conversely, when analyzing the financial indicator, DE-AU companies demonstrate markedly stronger results than their European counterparts. On average, the latter report a Net Debt/EBITDA ratio of about 2,7x compared the 2x of DE-AU companies. This trend is consistent across all sectors, underscoring the relatively lower financial leverage among German corporates.



These dynamics are further corroborated by credit quality assessments, which confirm higher credit quality within the DE-AU portfolio. While these companies tend to operate with tighter margins, they maintain substantially stronger financial profiles and lower leverage. This combination suggests a more conservative approach to capital structure and risk management, which may translate into greater resilience in periods of economic uncertainty. For investors and policymakers, these findings highlight the importance of sectoral and regional differentiation when assessing corporate credit risk and strategic positioning in the European market.



Emerging Challenges: a regulatory and macroeconomic perspective

Over the medium term, the banking sector is expected to deal with increasingly complex challenges, primarily driven by the need to mitigate exogenous shocks. These challenges encompass:

> Macroeconomic Risks

Recent projections by the European Commission indicate a modest upward revision of GDP growth estimates for 2025, from 1.1% to 1.4%. This adjustment reflects stronger-than-expected export performance ahead of anticipated tariff increases, a resilient labor market and a gradual decline in inflation, which remains slightly above the European Central Bank's 2% target. Nevertheless, the persistence of restrictive monetary policy has constrained domestic demand, thereby slowing consumption and investment. These dynamics suggest that the recovery process will be more protracted and complex than initially anticipated.

On the global stage, escalating trade tensions and tariff hikes continue to generate uncertainty, while regional conflicts exert upward pressure on commodity prices and indirectly erode business and consumer confidence. Such factors may weigh heavily on European exports and productive efficiency. Furthermore, the increasing frequency of climate-related disasters poses an additional structural risk, as the economic costs associated with these events are expected to rise, undermining resilience and long-term growth prospects.

> Regulatory Risks

From a regulatory standpoint, Basel III introduces the output floor mechanism for Risk-Weighted Assets (RWA) calculated under the IRB approach. This measure seeks to enhance transparency and comparability of capital requirements across the banking system, while mitigating volatility and underestimation of credit risk attributable to the heterogeneity of IRB models, both in terms of PD'S and LGD's assessment and in terms of quality of the data feeding internal models.

The output floor operates as a prudential safeguard, ensuring that banks maintain a minimum capital buffer to withstand adverse economic conditions. By imposing a lower bound on RWAs, the mechanism limits the extent of capital relief achievable through internal modeling. This threshold is determined by reference to ratings issued by External Credit Rating Agencies (ECRAs), in accordance with the standardized framework for External Credit Assessment Institutions (ECAIs). Formally, the requirement stipulates that total RWAs shall not fall below:

$$RWA_{Basel\ III} = \max\left(RWA_{IRB/AIRB}, \alpha \times RWA_{ECRA}\right)$$

The output floor requires that total RWA do not fall below a threshold equal to $\alpha \times RWA_{ECRA}$. Since January 1, 2025, a 50% coefficient has been applied, with gradual increases up to 72.5% by 2030, as shown in the following table:

	1st Jan 2025	1st Jan 2026	1st Jan 2027	1st Jan 2028	1st Jan 2029	1st Jan 2030
α	50%	55%	60%	65%	70%	72.5%

Takeaways

Loan origination and monitoring will constitute critical determinants of systemic stability. Proactive alignment with Basel III standards can foster greater consistency in risk assessment, reduce capital absorption, strengthen investor confidence, and attenuate the volatility of economic cycles, which are increasingly compressed into shorter temporal horizons.

Authors

Luca D'Amico
CEO
CRIF Ratings

Marco Bonsanto
Associate Director – Rating Department
CRIF

Dirk Burdorf
Senior Management Consultant
Banking
CRIF

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