The Role of Ratings in the New Era of Banking Regulation

On 1 January 2025, the revised capital regulation (Capital Requirements Regulation, CRR III) will come into effect, commonly referred to as Basel IV. In this context, on 19 June 2024, the Regulation (EU) 2024/1623 was published to implement these reforms into EU law. While various transitional provisions are intended to facilitate European credit institutions' adaptation to the new requirements, the regulation brings significant changes for both banks and corporates.

Key changes under Basel IV

The Standardized Approach (SA) has been revised to introduce more differentiated assessments for credit and operational risks. Additionally, disclosure requirements have been expanded, and new regulations for market risks and specialized financing have been established. A key innovation is the introduction of the output floor, which sets a minimum threshold for capital requirements calculated using internal models (Internal Ratings-Based, IRB). These requirements must be at least 72.5% of the capital requirements that would result from calculating all risk exposures under the Standardized Approach.

As a result, credit institutions will need to hold more capital and anticipate higher operational costs for risk management. Specifically, banks heavily reliant on internal models for risk measurement may need to hold significantly more capital. This is because these models tend to reflect lower risks than the Standardized Approach, which has previously led to lower capital requirements.

Borrowers will feel the impact indirectly

While Basel IV aims to enhance the resilience and stability of the banking sector in the European Union by introducing stricter rules for credit risk assessment and higher capital requirements, the new rules will also have an indirect impact on borrowers. Basel IV will be particularly significant for companies and banks without external ratings ("unrated corporates").

The rising capital requirements are likely to lead to higher borrowing costs. Moreover, stricter capital requirements may cause banks to be more selective in lending, potentially limiting credit availability for companies with lower creditworthiness or riskier investments.

Higher financing costs for unrated corporates

Companies without a rating are likely to experience even greater increases in borrowing costs.

(1) The risk sensitivity of the Standardized Approach has been adjusted so that capital requirements for unrated companies are generally higher than for rated companies.
(2) IRB banks must also consider the Standardized Approach when implementing the output floor, ensuring that capital requirements derived from internal models are no more than 27.5% lower than those calculated under the Standardized Approach.
(3) Basel IV imposes restrictions on the application of the Advanced IRB Approach (A-IRB) for certain portfolios. In the context we are considering, it is particularly relevant that the A-IRB will no longer be available for exposures to companies with consolidated annual revenues exceeding 500 million euros and to financial institutions.

Only one in ten large German companies has an external rating

It is noteworthy that as of mid-2024, only 9.2% of the 1,125 largest German companies have a rating from a credit rating agency (ECAI). This finding is particularly relevant in light of the upcoming tightening of capital requirements, as companies with an external rating are likely to receive more favorable financing terms.

To estimate the number of companies that could be affected by the implementation of Basel IV, we analyzed the financial data of companies that reported annual revenues of at least 500 million euros in 2022 and are neither subsidiaries of multinational foreign corporations nor part of a German corporate group.

This focus on large enterprises was chosen because they are more likely to have an external rating than smaller companies, thus providing a good estimate of the upper bound of German companies with external ratings. These companies are also more likely to be affected by at least one of the three factors mentioned above, which could lead to less favorable financing conditions.

High share of ratings in capital-intensive sectors

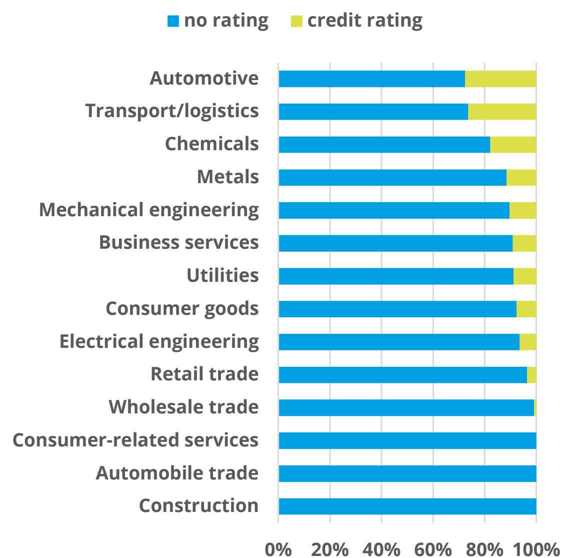
The automotive industry (27.6%), the logistics sector (26.3%), and the chemical industry (17.9%) have comparatively high shares of large corporates with external ratings (see Figure 1). This may reflect the need to demonstrate strong creditworthiness and transparency for significant investments.

Conversely, in technology-intensive industries, relatively few large enterprises are rated. Only 10.3% of large companies in mechanical engineering and 11.5% in the metal industry have a rating. The share is even lower in the electrical engineering and consumer goods industries, with 6.5% and 7.7% of companies rated, respectively.

Notably, in the construction industry, the automobile trade, and consumer-related service providers, no large enterprises have an external rating. This could indicate specific industry risks or a low reliance on external financing in these sectors. Alternatively, it may reflect the fact that these are industries with limited capital market exposure and relatively few bond issuances. The wholesale and retail trade sectors also have a very high share of unrated companies.

Figure 1: Share of large German companies with ratings in selected industries

In %, as of 12 July 2024



Source: Creditreform Rating

Many unrated companies could demonstrate strong creditworthiness

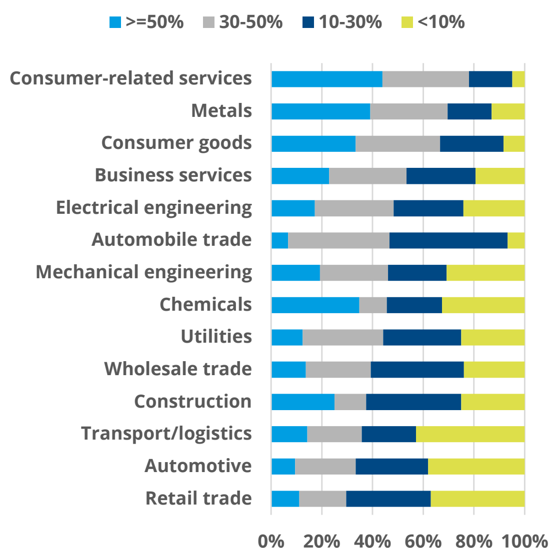
We expect the willingness to obtain an external rating to increase over the long term, as the reformed capital requirements create incentives for a credit assessment by a rating agency.

To illustrate that there are a significant number of unrated companies with strong balance sheets in certain industries, we calculated companies' equity ratios as a proxy for balance sheet creditworthiness. We then grouped the results by equity ratio in the respective industries (see Figure 2).

Our analysis shows that large unrated companies in many industries have very high equity ratios. In several industries, at least half of the large enterprises have an equity ratio of more than 30%. We believe that these companies could potentially receive a favorable external rating, which could positively affect credit availability and related financing conditions.

Figure 2: Equity buffers of unrated German large enterprises

Share of companies by equity ratio in %



Source: Creditreform Rating

Consumer-related services, in particular, show exceptionally high financial stability, with four out of five unrated large companies (78.0%) in this sector having an equity ratio of at least 30%. Similarly, the metal industry and consumer goods industry are dominated by highly capitalized companies. With 69.6% and 66.7% of companies respectively having an equity ratio above 30%, these sectors exhibit a very strong equity structure.

By contrast, the retail trade and the logistics sectors tend to have lower equity ratios. In retail trade, 37.0% of unrated large enterprises have an equity ratio of less than 10%, and in the logistics sector, the figure is as high as 42.9%. The automotive industry is relatively evenly distributed across classes, but even here the share of low-capitalized companies is relatively high (38.1%).

Companies should prepare early for the new Basel IV framework

Overall, banks may apply stricter lending criteria and/or less favorable financing conditions to unrated companies to compensate for the higher capital requirements resulting from the increased risk weights. The output floor is expected to have the most significant impact and fundamentally change the way banks do business.

While Basel IV includes transitional provisions to help banks adjust their capital calculations to the new requirements, many banks have already begun to prepare intensively for the new rules by factoring their capital requirements into planning scenarios as if it were already 2030, when, e.g., the output floor regulations would set a threshold of 72.5%.

Borrowers should therefore begin to consider the potential impact of Basel IV on their financing costs and credit availability. Ratings can help companies better position themselves in the market and potentially gain access to more favorable financing terms.

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