Supranational Rating Methodology

Feedback Report

Analysts

Alvise Lennkh-Yunus
+49 69 6677 38985
a.lennkh@scoperatings.com

Julian Zimmermann
+49 69 6677 389 89
j.zimmermann@scoperatings.com

Dr Giacomo Barisone
+49 69 6677 389 22
g.barisone@scoperatings.com

Media

Matthew Curtin
+33 9 52 72 86 85
m.curtin@scopegroup.com

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Scope Ratings would like to thank market participants who provided feedback on its proposed supranational rating methodology, published on 10 May 2024. This report addresses comments received on a confidential basis during the call for comments period, which ended 10 June 2024.

1. General considerations

1.1. Impact on ratings

To fully understand the methodology, will you allow us to review the individual scores before the methodology is applied to our ratings?

- Scope's answer

As part of the regulatory requirement every issuer receives the rating documents prior to their publication to review any factual errors. The updated methodology has no rating impact.

2. Financial profile

2.1. Callable capital

The default 5% attribution seems very low relative to the credit quality and statutory embedding of such support. We wonder how this figure was reached, and why such high-quality sovereign commitments are given such limited credit. This, especially in view of the remoteness of such scenarios and implied delivery lead time. Regarding advance appropriation, the concept seems unduly penalising for holders of such very remote contingent liabilities, and it is unclear if this relates to partial or full appropriation.

- Scope's answer

We acknowledge that the 5% attribution for high-quality sovereign commitments is conservative not least given the implied delivery lead time in view of the remoteness of such scenarios. In addition, the recent publications of several leading supranationals provide further transparency and assurance on the reliability of this instrument. The reports include detailed surveys from shareholder governments on their commitment to and treatment of callable capital, including the timelines to honour a call. Consequently, we have increased the final attribution to 10%.

At the same time, it is important to note that without explicit appropriation, callable capital is not earmarked for a specific institution. Given its untested nature, a higher attribution is only feasible if callable capital is specifically appropriated for an institution, particularly since government priorities may shift during times of stress. It is also unclear whether a government could revoke such appropriations under exceptional circumstances, contrary, for example, to hybrid instruments where legal contracts ensure the conversion (and provision) of capital to absorb losses.

Please see section 2.2.1.1. Callable capital in the methodology.

2.2. Climate risks – general

It would be helpful to better understand how you weigh and combine the factors. For example, while we recognise the motivation to consider factors such as geographical and sector distribution, or remaining maturity, for institutions with very strong climate risk management, it may be that the latter outweighs other factors.

- Scope's answer

We appreciate the interaction between climate risk exposure and risk management. For this reason, we assess high climate risk exposures as being mitigated provided the institution has aligned its risk management practices with the Paris Agreement, including policies that outline a clear path towards alignment over a certain period.

2.3. Climate risks – data, thresholds and assessment

It is not clear which data you will use for the assessment nor why there is a cumulative addition of physical and transition risk, whereas the underlying assets could overlap. We also wonder how you have calibrated the thresholds, and if these adequately account for the ability to manage those risks. For example: These thresholds could unduly penalise institutions inclined towards a more conservative risk management approach with more cautious coverage and management of their portfolio climate risks. Would it therefore be helpful to combine this in an assessment of risk management practice and outcomes?

- Scope's answer

We assume that our estimate of the borrower quality of a supranational's sovereign and public sector exposure sufficiently captures potential physical and transition risks, since these are already assessed via our sovereign methodology which incorporates a 4% weight in our quantitative model and an additional 1/3 notch qualitative assessment. Our sovereign rating serves as an anchor for both types of exposures eliminating the need to adjust our borrower quality estimate for these exposures further for any potential climate risks.

Moreover, for financial institutions, we assume that their climate-risk exposure broadly mirrors that of the economy and operating environment, given usually widely diversified loan portfolios. We therefore do not make an adjustment to our borrower quality estimate for a supranational's exposure to financial institutions.

However, for non-financial sector exposures, we may adjust our borrower quality estimate at the portfolio level by up to two notches negatively depending on the share of the portfolio that we identify as having high climate risks. This is necessary because climate risks for non-financial corporate exposures can vary significantly geographically and across economic sectors.

To assess physical risks, we use the Notre Dame Global Adaptation Initiative (ND-GAIN) Country Index Scores. More granular physical risks assessments are not feasible as this depends on the precise location of the projects and counterparties of the supranational and physical risk assessments at a very narrow geographical level.

Acknowledging the limitations, we classify countries by risk category via percentiles and assume that the physical risk of non-financial private sector exposures is correlated with the overall physical risk score of the country. We acknowledge that physical risks of the exposures to the private sector in countries assessed as having high (low) physical risks can still be low (high). For some supranationals operating mostly in low-income economies, the underlying assets identified as having high physical risks could also be identified as having high transition risks.

Still, we believe the risk of double-counting climate risks is limited. Physical risks are more prevalent in low- and middle-income economies which often do not yet have strict regulatory frameworks and policies that result in high transition risks. On the other hand, transition risks are usually more prevalent in advanced economies, which, on average, have lower physical risks.

To assess transition risks for corporate exposures we first identify the share of exposures in sectors with high transition risks per UNEP FI's classification of overall transition risk per sector. On this basis, we add the share of the non-financial corporate portfolio identified as having either high physical risks (based on ND-GAIN at the country level) or high transition risks (for corporate exposures based on UNEP FI's sector classification).

We then adjust this share by the outstanding maturity of the loan portfolio. We fully reduce the exposure's gross amount in case its remaining tenor is of one year or less, assuming the exposure's short remaining life effectively mitigates climate risks.

Exposures with a remaining tenor of over one year and up to seven years receive a 50% reduction, while exposures with a remaining tenor of over seven years are fully accounted for. If the maturity split is not available per sector, we use the supranational's overall average outstanding maturity of its loan portfolio. Finally, should the operations be identified as supporting the transition towards alignment with the Paris Agreement, we treat them as mitigated climate risks.

On this basis, should we estimate that more than 25% (50%) of the non-financial sector portfolio is exposed to high climate risks (the sum of the share of the portfolio exposed to high physical and transition risks after mitigants) we will adjust our estimate of the borrower quality of the non-financial sector portfolio by one (two) notch(es).

Please see section 2.2.2.1. Portfolio quality in the methodology.

2.4. Climate risks – unclassified climate risk exposures

How does Scope treat exposures where the issuer does not (yet) screen for (or classify) climate risks? How does Scope take into account mitigating policies?

- Scope's answer

We estimate climate risks at the portfolio level and adjust our estimate of exposures with high climate risks by maturity. In addition, exposures identified as having high climate risks will be adjusted for mitigation strategies, including when those operations are aligned with or support the transition towards alignment with the Paris Agreement's goals.

2.5. Climate risks – additional information

What kind of information you are expecting to receive to complement your assessment?

- Scope's answer

To enhance our assessment, it would be helpful to receive information on a supranational's identified physical risks of its non-financial corporate portfolio. Ideally, such self-assessments could be based on a joint methodology of leading supranationals with comparable underlying assumptions, scales and metrics, including how those risk assessments relate to the standard credit risk assessments of the portfolio. Ability to access the data underlying TCFD reports would be very valuable.

Moreover, it would be helpful to receive information about the share of the portfolio that the supranational identifies as being exposed to both, transition and physical risks. Finally, information on the average outstanding loan maturities at the sectoral level, rather than the overall average maturity of the portfolio only, would also improve the assessment.

2.6. Concessional finance

A narrow view of concessional finance disregards the ability to influence key structural change (e.g. policy dialogue and technical support for clients and host countries), and the fact that supranationals may specialise and cooperate.

- Scope's answer

The updated methodology now specifies that technical assistance, policy dialogue and the degree of cooperation among supranationals are also forms of concessional finance.

Please see section 2.1.1. Importance of mandate.

2.7. Capitalisation approach

Is there a reason that you've decided not to use a capital adequacy model (with individual asset / risk weight input), which would seem to be more precise when it comes to assessing an intrinsic rating?

- Scope's answer

We focus on a through-the-cycle, mandate-driven approach relying on maximum mandated leverage as well as actual leverage. In addition, to ensure comparability across supranationals, we focus on the overall portfolio-level quality in the asset quality section.

2.8. Disbursements

What do you envisage under "credibly announced future disbursement plans"? Does this mean you will only look at publicly available information or will you enter into a dialogue with the issuer?

- Scope's answer

We will primarily use public information, for example, strategic documents as well as borrowing plans. When available, this will be complemented by information provided by the issuer.

2.9. Guarantees and credit uplift

Will an MDB only benefit by two notches for a Basel compliant financial guarantee by a AA- rated entity? Are there any circumstances in which you would consider replacing the risk exposure of the project with that of the guarantor?

- Scope's answer

For unconditional, unlimited, direct, and irrevocable guarantees on non-sovereign exposures, we allow for credit substitution. More generally, we will assess a fully protected portfolio two categories, that is, six notches, above our initial portfolio quality assessment.

Please see section 2.2.2.1. Portfolio quality in the methodology.

2.10. Non-performing loans

NPLs are not only a reflection of a supranational's project selection and risk management. It may also reflect the mandate and would benefit from being viewed holistically with e.g. the policy importance and a conservative balance sheet, growing retained profits etc.

- Scope's answer

The updated methodology references that asset quality more broadly, including the NPL ratio, also reflects a supranational's mandate.

Please see section 2.2.2.2. Asset performance in the methodology.

3. Shareholder support

3.1. Capital call mechanisms

Your approach to call mechanisms could warrant greater clarification: It would be helpful to indicate which qualitative factors can provide comfort, including legal value and clarity on governance – such as Statutory designation of decision makers and circumstances for decisions.

- Scope's answer

We view positively capital call mechanisms that i) allow callable capital to be used widely (not just for honouring liabilities in emergencies) but also to compensate for sustained losses; ii) clarify in advance the timeline for supranationals to receive called capital from their shareholders, with short timelines that are broadly aligned across all shareholders (implying a similar budgetary treatment of callable capital by shareholders); iii) have strong legal underpinnings and are enforceable through international courts; and iv) specify that lending operations and/or voting rights may be suspended if a call is not honoured.

Please see section 3.1.2. Willingness to provide support in the methodology.

3.2. Capital increases and low paid-in ratios

You signal concern about any absence of shareholder capital increases and or low paid-in ratios: While you duly consider the overall history of an institution, we propose to be mindful of unintended consequences, for example, to avoid penalising: a) those operating on a largely self-sufficient basis following initial capitalisation – where an institution can further build equity autonomously through retained earnings, and b) highly capital efficient institutions.

- Scope's answer

These considerations have been incorporated in the final version of the methodology.

Please see section 3.1.2. Willingness to provide support in the methodology.

Scope Ratings GmbH

Lennéstraße 5
D-10785 Berlin
scoperatings.com

Phone: +49 30 27891-0
Fax: +49 30 27891-100
info@scoperatings.com

Bloomberg: RESP SCOP
Scope contacts

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