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Mapping of Spread Research credit assessments under the Standardised Approach

1. Executive summary

1. This report describes the mapping exercise carried out by the Joint Committee to determine the 'mapping'[1] of the credit assessments of Spread Research (SR).

2. The methodology applied to produce the mapping is a combination of the provisions laid down in Article 136(2) Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR) and those proposed in the Consultation paper on draft Implementing Technical Standards on the mapping of ECAIs' credit assessments under Article 136(1) and (3) of Regulation (EU) No 575/2013 published on 5 February 2014 (draft ITS).

3. The mapping neither constitutes the one which ESMA shall report on in accordance with Article 21(4b) of Regulation (EC) No 1060/2009 (Credit Rating Agencies Regulation - CRA) with the objective of allowing investors to easily compare all credit ratings that exist with regard to a specific rated entity nor should be understood as a comparison of the rating methodologies of SR with those of other ECAIs. This mapping should however be interpreted as the correspondence of the rating categories of SR with a regulatory scale which has been defined for prudential purposes. This implies that an appropriate degree of prudence may have been applied wherever not sufficient evidence has been found with regard to the degree of risk underlying the credit assessments.

4. The resulting mapping tables have been specified in Annex III of the addendum to the draft ITS published today. Figure 1 below shows the result for the only rating scale of SR, the International long-term rating scale, together with a summary of the main reasons behind the mapping proposal for each rating category.

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[1] According to Article 136(1), the 'mapping' is the correspondence between the credit assessments of and ECAI and the credit quality steps set out in Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR).

Figure 1: Mapping of SR's International long-term rating scale

Credit assessment	Credit quality step	Main reason
AAA	2	The quantitative factors are representative of the final CQS.
AA	2	
A	3	The quantitative factors are representative of CQS 2. As only limited information is available on the default definition, CQS 3 has been assigned.
BBB	4	The quantitative factors are representative of CQS 3. As only limited information is available on the default definition, CQS 3 has been assigned.
BB	5	The quantitative factors are representative of the final CQS.
B	6	The quantitative factors are representative of the final CQS.
CCC	6	The quantitative factors are representative of the final CQS
CC	6	
C	6	
D	6	The meaning and relative position of the rating category is representative of the final CQS.

2. Introduction

5. This report describes the mapping exercise carried out by the Joint Committee (JC) to determine the 'mapping' of the credit assessments of Spread Research (SR).

6. SR is a credit rating agency that has been registered with ESMA in 1 July 2013 and therefore meets the conditions to be an eligible credit assessment institution (ECAI)[2].

7. The methodology applied to produce the mapping is a combination of the provisions laid down in Article 136(2) CRR and those proposed in the Consultation paper on draft Implementing Technical Standards on the mapping of ECAIs' credit assessments under Article 136(1) and (3) of Regulation (EU) No 575/2013 published on 5 February 2014 (draft ITS). Only public information has been available and access to relevant information, such as the default behaviour of the rated items, has been limited. This has conditioned the accuracy of the analysis and explains the additional degree of prudence applied to the final mapping proposal.

8. The mapping neither constitutes the one which ESMA shall report on in accordance with Article 21(4b) of Regulation (EC) No 1060/2009 (Credit Rating Agencies Regulation - CRA) with the objective of allowing investors to easily compare all credit ratings that exist with regard to a specific rated entity nor should be understood as a comparison of the rating methodologies of SR with those of other ECAIs. This mapping should however be interpreted as the correspondence of the rating categories of SR with a regulatory scale which has been defined for prudential purposes. This implies that an appropriate degree of prudence may have been applied wherever not sufficient evidence has been found with regard to the degree of risk underlying the credit assessments.

9. Section 3 describes the relevant ratings scales of SR for the purpose of the mapping. Section 4 contains the methodology applied to derive the mapping of SR's rating scale International long-term rating scale. The mapping table is shown in Appendix 4 of this document and have been specified in Annex III of the addendum to the draft ITS published today.

3. SR credit ratings and rating scales

10. SR produces one type of credit ratings, namely **Corporate rating**, shown in Column 2 of Figure 2 in Appendix 1. This credit rating may be used by institutions for the calculation of risk weights under the Standardised Approach (SA)[3].

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[2] It is important to note that the mapping does not contain any assessment of the registration process of SR carried out by ESMA.

[3] As explained in recital 2 draft ITS, Article 4(1) CRA allows the use of the credit assessments for the determination of the risk-weighted exposure amounts as specified in Article 113(1) CRR as long as they meet the definition of credit rating in Article 3(1)(a) CRA.

11. Spread Research assigns corporate ratings only, not ratings to debt instruments. This rating is a measure of the future credit quality of an issuer within a 6- to 12- month horizon, expressed as a Probability of Default (and not an Expected Loss).

12. SR assigns these credit ratings to the **International long-term rating scale**, as illustrated in column 3 of Figure 2 in Appendix 1. Therefore, a specific mapping has been prepared for this rating scale. The specification of the International long-term rating scale is described in Figure 3 of Appendix 1.

13. The mapping of the Long-term credit rating scale is explained in Section 4 and it has been derived in accordance with the quantitative factors, qualitative factors and benchmarks specified in the draft ITS.

4. Mapping of SR's International long-term rating scale

14. The mapping of the International long-term rating scale has consisted of two differentiated stages where the quantitative and qualitative factors as well as the benchmarks specified in Article 136(2) CRR have been taken into account. Figure 7 in Appendix 4 illustrates the outcome of each stage.

15. In the first stage, the quantitative factors referred to in Article 1 draft ITS have been taken into account to differentiate between the levels of risk of each rating category. More specifically, the *long run default rate* of a rating category has been used to arrive at an initial mapping proposal by comparing its value with the benchmark specified in Article 15(2) draft ITS.

16. In a second stage, the qualitative factors proposed in Article 8 draft ITS have been considered to challenge the result of the previous stage.

4.1. Initial mapping based on the quantitative factors

4.1.1. Calculation of the long-run default rates

17. CEREP does not contain any information regarding the ratings produced by SR. Therefore, the calculation of the short and long run default rates cannot be made as specified in Articles 2 – 4 of the draft ITS. Therefore, the allocation of the CQS has been made in accordance with Article 7 of draft ITS, as shown in Figure 4 of Appendix 3.

18. For D rating category, no calculation of default rate has been made since it already reflects a 'default' situation.

4.1.2. Mapping proposal based on the long run default rate

19. As illustrated in the second column of Figure 5 in Appendix 4, the assignment of the rating categories to credit quality steps has been initially made in accordance with Article 7 of draft ITS. Therefore, the numbers of defaulted and non-defaulted rated items have been used

together with the prior expectation of the equivalent rating category of the international rating scale. The results are specified in Figure 4 of Appendix 3:

- **AAA/AA, BB and B**: the number of rated items in these two categories is not sufficient to justify the credit quality step associated with the AAA/AA, BB and B rating categories in the international rating scale (CQS 1, CQS 4 and CQS 5 respectively). Therefore, the proposed credit quality steps for these rating categories are CQS 2, CQS 5 and CQS 6.

- **A and BBB:** the number of rated items in these two categories is sufficient to justify the credit quality step associated with the A and BBB rating categories in the international rating scale: CQS 2 and CQS 3 respectively.

- **CCC-C:** since the CQS associated with the equivalent rating category of the international rating scale is 6, the proposed mapping for these rating categories is also CQS 6.

4.2. Final mapping after review of the qualitative factors

20. The qualitative factors specified in Article 8 draft ITS have been used to challenge the mapping proposed by the default rate calculation. Qualitative factors acquire more importance in the rating categories where quantitative evidence is not sufficient to test the default behavior, as it is the case for all SR's rating categories.

21. The **definition of default** applied by SR and used for the calculation of the quantitative factors has been analysed:

- The types of default events considered are described in Appendix 2 and are consistent with letters (a) and (b) of the definition of default under certain conditions of the benchmark definition specified in Article 5(3) draft ITS, which means it is less strict than the benchmark default definition, and does not include all the default types required according to the draft ITS.

- There is no sufficient information to assess SR's definition of default by estimating the share of bankruptcy-related events. Therefore, the definition cannot be adjusted accordingly.

Due to these uncertainties a conservative approach has been chosen. This means that all rating categories are assigned a more conservative CQS. More specifically, rating category A is assigned CQS 3 instead of 2, and rating category BBB is assigned CQS 4 instead of 3. Other rating categories were assigned a more conservative CQS in the first step of the mapping based on quantitative factors, and therefore no change in the mapping should be proposed due to this factor.

22. Regarding **the meaning and relative position of the credit assessments**, it would suggest a more favorable CQS than the one proposed so far. However this qualitative factor cannot overrule the lack of quantitative information and therefore no change is proposed.

23. Regarding the **time horizon** reflected by the rating category, it is a 6- to 12- month, significantly lower than the 3-year horizon established for the calculation of the default rates. However, the absence of rating data does not allow the use of this factor.

24. Finally, it should be highlighted the use of the long run default rate benchmark associated with the equivalent category in the international rating scale as the **estimate of the long run default rate** for the calculation of the quantitative factor of all rating categories under Article 7 draft ITS.

Appendix 1: Credit ratings and rating scales

Figure 2: SR's relevant credit ratings and rating scales

SA exposure classes	Name of credit rating	Credit rating scale
Long-term ratings		
Corporates	Corporate rating	International long-term rating scale

Source: Spread Research

Figure 3: International long-term rating scale

Credit assessment	Meaning of the credit assessment
AAA	(no definition available)
AA	(no definition available)
A	(no definition available)
BBB	(no definition available)
BB	Strong business risk profile (stable and predictable cash flows), positive FCF and/or low leverage
B	Weak business risk profile, negative FCF and/or high leverage
CCC	Very high leverage, negative FCF, weak liquidity and/or restructuring/default likely
CC	Out-of-court consensual restructuring
C	In-court restructuring
D	Missed payment on interest or principal (post-grace period)

Source: Spread Research

Appendix 2: Definition of default

Spread Research defines a default as either:

(i)   a missed payment (post-grace period) on a coupon or the debt principal;

(ii)   an in-court restructuring (e.g. filing for bankruptcy; Chapter 11; in-court restructuring resulting in a debt-for-equity swap; etc.); or

(iii)   a liquidation.

Source: Spread Research

Appendix 3: Default rates of each rating category

Figure 4: Mapping proposal for rating categories with a non-sufficient number of credit ratings

	AAA/AA	A	BBB	BB	B	CCC-C
CQS of equivalent international rating category	CQS 1	CQS 2	CQS 3	CQS 4	CQS5	CQS 6
N. observed defaulted items	0	0	0	0	0	0
Minimum N. rated items	496	0	0	10	5	n.a.
Observed N. rated items	0	0	0	0	0	0
Mapping proposal	**CQS2**	**CQS 2**	**CQS 3**	**CQS 5**	**CQS 6**	**CQS 6**

Source: Joint Committee analysis

Appendix 4: Mappings of each rating scale

Figure 5: Mapping of SR's International long-term credit rating scale

Credit assessment	Initial mapping based on LR DR (CQS)	Review based on SR DR (CQS)	Final review based on qualitative factors (CQS)	Main reason for the mapping
AAA	2	n.a.	2	The quantitative factors are representative of the final CQS.
AA	2	n.a.	2	
A	2	n.a.	3	The quantitative factors are representative of CQS 2. As only limited information is available on the default definition, CQS 3 has been assigned.
BBB	3	n.a.	4	The quantitative factors are representative of CQS 3. As only limited information is available on the default definition, CQS 3 has been assigned.
BB	5	n.a.	5	The quantitative factors are representative of the final CQS.
B	6	n.a.	6	The quantitative factors are representative of the final CQS.
CCC	6	n.a.	6	The quantitative factors are representative of the final CQS.
CC	6	n.a.	6	
C	6	n.a.	6	
D	6	n.a.	6	The meaning and relative position of the rating category is representative of the final CQS.