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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 the one specified in the Implementing Technical Standards on the mapping of ECAIs’ credit assessments under Article 136(1) and (3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR). These ITS employ a combination of the provisions laid down in Article 136(2) of Regulation (EU) No 575/2013.
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 entity² 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. As described in Recital 12 of the Implementing Technical Standards on the mapping of ECAIs’ credit assessments under Article 136(1) and (3) of Regulation (EU) No 575/2013, in order to avoid causing undue material disadvantage on those ECAIs which, due to their more recent entrance in the market, present limited quantitative information, with the view to balancing prudential with market concerns, two mappings apply for these ECAIs, with the first mapping for a limited period of three years. Both mappings should take into account quantitative and qualitative factors. Compared to the second mapping, the quantitative factors for deriving the first mapping should be relaxed. This solution would allow ECAIs which present limited

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).

² In this regard please consider http://www.esma.europa.eu/system/files/esma__2015-1473_report_on_the_possibility_of_establishing_one_or_more_mapping....pdf.

quantitative information to enter the market and would positively stimulate them to collect a sufficient number of quantitative information.

5. In accordance with the previous paragraph for a subset of ECAs two mappings are applicable, one applicable until 31.12.2018 and one applicable from 01.01.2019. SR belongs to the subset of ECAs that are provided two mappings. Updates to the mapping should be made whenever this becomes necessary, including in relation to the mapping to be applied after the three years, to reflect quantitative information collected during the three year-period. Nevertheless, in the absence of such a review, for the ECAs that are provided two mappings the one applicable from 01.01.2019 shall operate after the three years phase-in period.
6. The resulting mapping tables have been specified in Annex III of the Implementing Technical Standards on the mapping of ECAs' credit assessments under Article 136(1) and (3) of Regulation (EU) No 575/2013. Figure 1 below shows the result for the only rating scale of SR, the International long-term rating scale, displaying the mapping applicable until 31.12.2018 and the one applicable starting from 01.01.2019.

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

Credit assessment	Credit quality step Applicable until 31.12.2018	Credit quality step Applicable from 01.01.2019
AAA	1	2
AA	1	2
A	2	2
BBB	3	3
BB	4	5
B	5	6
CCC	6	6
CC	6	6
C	6	6
D	6	6

2. Introduction

7. 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).
8. 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)³.
9. The methodology applied to produce the mapping is the one specified in the Implementing Technical Standards on the mapping of ECAIs' credit assessments under Article 136(1) and (3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR). These ITS employ a combination of the provisions laid down in Article 136(2) of Regulation (EU) No 575/2013. The information base used to produce the mapping is the same that has been employed when performing the first mapping proposal which was disclosed during the consultation period to these ITS. At that time, as SR did not yet submit information to ESMA Central Repository (CEREP⁴), the main source of information was the credit rating agency itself. On the one hand, the quantitative and qualitative information provided by SR has been used to obtain an overview of the main characteristics of this ECAI. On the other hand, information regarding the types of credit ratings produced and the definition of the applicable rating scales has also been taken into account.
10. The following sections describe the rationale underlying the mapping exercise carried out by the Joint Committee (JC) to determine the mappings for both the applicable time periods. With respect to the quantitative requirements used to perform the mappings, in case of ECAIs for which limited quantitative information is available the same methodology has been applied across the two applicable time periods, although with two different levels of prudence. 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 Implementing Technical Standards on the mapping of ECAIs' credit assessments under Article 136(1) and (3) of Regulation (EU) No 575/2013.

3. SR credit ratings and rating scales

11. 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)⁵.

³ It is important to note that the mapping does not contain any assessment of the registration process of SR carried out by ESMA.

⁴ CEREP is the central repository owned by ESMA to which all registered/certified CRAs have to report their credit assessments. <http://cerrep.esma.europa.eu/cerep-web/>.

⁵ As explained in recital 4 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.

12. 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).
13. 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.
14. 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 ITS.

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

15. 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.
16. In the first stage, the quantitative factors referred to in Article 1 of the ITS have been taken into account to differentiate between the levels of risk of each rating category. The *long run default rate* of a rating category has been calculated in accordance with Article 6 of the ITS, as the number of credit ratings cannot be considered to be sufficient.
17. In a second stage, the qualitative factors proposed in Article 7 of the 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

18. 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 3 – 5 of the ITS. Therefore, the allocation of the CQS has been made in accordance with Article 6 of the ITS, as shown in Figure 4 and Figure 5 of Appendix 3.
19. 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

20. As illustrated in the second column of Figure 6 and Figure 7 in Appendix 4, the assignment of the rating categories to credit quality steps has been initially made in accordance with Article 6 of the 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.

Mapping Tables applicable until 31.12.2018:

- **AAA/AA/A/BBB/BB/B**: the number of rated items in each of these categories is equal or larger than the respective minimum required number of observed items given the number of defaulted items in the rating category. Thus the credit quality step associated with the AAA/AA, A, BBB, BB, B rating categories in the international rating scale (CQS 1, CQS 2, CQS 3, CQS4 and CQS 5 respectively) can be assigned.
- **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.

Mapping Tables applicable starting from 01.01.2019:

- **AAA/AA/BB/B**: the number of rated items in these categories is below the minimum required number of observed items so that the credit quality step associated with the AAA/AA, BB, B rating categories in the international rating scale (CQS 1, CQS 4 and CQS 5 respectively) cannot be assigned. Therefore the proposed credit quality steps for these rating categories are CQS 2, CQS 5 and CQS 6 respectively.
- **A/BBB**: the number of rated items in each of these categories is equal or larger than the respective minimum required number of observed items given the number of defaulted items in the rating category. Thus the credit quality step associated with the A and BBB rating categories in the international rating scale (CQS 2 and CQS 3 respectively) can be assigned.
- **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

21.The qualitative factors specified in Article 7 of the 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 behavior⁶, as it is the case for all SR's rating categories.

22.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), (b) and (c) of the definition of default under certain conditions of the benchmark definition specified in Article 4(4) of the ITS, however it does not consider the

⁶ The default behavior of a rating category is considered to be properly tested if the quantitative factors for that rating category are calculated under Articles 3 – 5 ITS.

(d) default event because SR does not rate any financial institution. This means that SR definition of default is comparable with the benchmark default definition.

- Based on the information provided by SR, the share of bankruptcy-related events in its definition of default is below 50%.

Therefore, no specific adjustment has been proposed based on this factor.

23.Regarding **the meaning and relative position of the credit assessments**, with respect to the mapping tables applicable starting from 01.01.2019, it would suggest a more favorable mapping for rating categories AAA/AA, BB and B. However this qualitative factor cannot overrule the lack of quantitative information and therefore no change is proposed.

24.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.

25.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 6 of the 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	Highest credit quality and extremely low business and financial risk.
AA	Very large scale and very high level of diversification, very low-risk business (proven resilience through economic crisis), very high FCF and very low leverage
A	Large scale and high level of diversification, low-risk business (proven resilience through economic cycles), high FCF and low leverage
BBB	Large scale and high level of diversification, low-risk business (proven resilience through economic cycles), positive FCF and/or low leverage
BB	Medium/low-risk business (stable and predictable cash flows), positive FCF and/or low leverage
B	High-risk business , 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 or delayed payments on interest or principal on the due date or in the stated grace period if any, unless Spread Research considers such payments will occur during this grace period;
- (ii) An in-court restructuring leading to a failure to fulfill present or future financial obligations such as a missed payment on interest or principal or debt for equity swap;
- (iii) a liquidation.

In addition, the C rating of Spread Research corresponds to an in-court restructuring without a failure to fulfil present or future financial obligations such as a missed payment on interest or principal or debt for equity swap. This rating event does not happen often and Spread Research never experienced it.

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, applicable until 31.12.2018

	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	0	0	0	0	0	n.a.
Observed N. rated items	0	0	0	0	0	0
Mapping proposal	CQS 1	CQS 2	CQS 3	CQS 4	CQS 5	CQS 6

Source: Joint Committee analysis

Figure 5: Mapping proposal for rating categories with a non-sufficient number of credit ratings, applicable starting from 01.01.2019

	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	CQS 2	CQS 2	CQS 3	CQS 5	CQS 6	CQS 6

Source: Joint Committee analysis

Appendix 4: Mappings of each rating scale

Figure 6: Mapping of SR's International long-term credit rating scale, applicable until 31.12.2018

Credit assessment	Initial mapping <i>based on LR DR</i> (CQS)	Review <i>based on SR</i> <i>DR</i> (CQS)	Final review <i>based</i> <i>on qualitative</i> <i>factors</i> (CQS)	Main reason for the mapping
AAA	1	n.a.	1	The quantitative factors are representative of the final CQS.
AA	1	n.a.	1	
A	2	n.a.	2	
BBB	3	n.a.	3	The quantitative factors are representative of the final CQS.
BB	4	n.a.	4	The quantitative factors are representative of the final CQS.
B	5	n.a.	5	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.

Figure 7: Mapping of SR's International long-term credit rating scale, applicable until 01.01.2019

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.	2	
BBB	3	n.a.	3	The quantitative factors are representative of the final CQS.
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.