Mapping of modeFinance's credit assessments under the Standardised Approach

1. Executive summary

1. This report describes the exercise carried out by the Joint Committee (JC) to determine the 'mapping'[1] of the credit assessments of modeFinance S.r.l. (modeFinance).

2. The methodology applied to produce the mapping remains as specified in the Commission's Implementing Regulation (EU) 2016/1799 ('the Implementing Regulation') laying down Implementing Technical Standards (ITS) with regard to the mapping of credit assessments of External Credit Assessment Institutions (ECAIs) for credit risk in accordance with Articles 136(1) and (3) of the Regulation (EU) No 575/2013 of the European Parliament and the Council ('the CRR'). This Implementing Regulation employs a combination of the provisions laid down in Article 136(2) CRR.

3. The mapping neither constitutes the one which the European Securities and Markets Authority (ESMA) shall report on in accordance with Article 21(4b) of Regulation (EC) No 1060/2009 (the 'CRA Regulation') with the objective of allowing investors to easily compare all credit ratings that exist with regard to a specific rated entity[2] nor should be understood as a comparison of the rating methodologies of modeFinance with those of other ECAIs. This mapping should however be interpreted as the correspondence of the rating categories of modeFinance 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 Regulation, it is necessary 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. Therefore, the relevance of quantitative factors for deriving the mapping should be relaxed. This allows ECAIs which present limited quantitative information to enter the market and increases competition. Updates to the mapping should be made wherever this

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

[2] In this regard please see https://www.esma.europa.eu/sites/default/files/library/esma_2015-1473_report_on_the_possibility_of_establishing_one_or_more_mapping.pdf.

becomes necessary to reflect additional quantitative information collected after the entry into force of the revised draft ITS.

5. The resulting mapping has been specified in Annex III of the revised draft ITS on the mapping of ECAIs' credit assessments under Article 136(1) and (3) of the CRR. Figure 1 below shows the result for the only rating scale of modeFinance, the global long-term rating scale.

Figure 1: Mapping of modeFinance's global long-term rating scale

Credit assessment	Credit quality step
A1	1
A2	1
A3	2
B1	3
B2	4
B3	5
C1	6
C2	6
C3	6
D	6

2. Introduction

6. This report describes the exercise carried out by the JC to determine the 'mapping' of the credit assessments of modeFinance.

7. modeFinance is a credit rating agency that registered with ESMA on 10 July 2015 and therefore meets the conditions to be an eligible ECAI[3].

8. The methodology applied to produce the mapping remains as specified in the Implementing Regulation, which employs a combination of the provisions laid down in Article 136(2) of the CRR, including quantitative and qualitative factors. The quantitative information reflects the statistics on the rating activity and performance of ECAIs established by ESMA in its Central Repository of credit rating data (CEREP)[4, 5]. The qualitative information was collected bilaterally from modeFinance.

9. The following sections describe the rationale underlying the exercise carried out by the JC to determine the mapping. Section 3 describes the rating scale of modeFinance for the purpose of the mapping. Section 4 contains the methodology applied to derive the mapping of modeFinance's rating scale. The mapping table is shown in Appendix 4 of this document.

3. modeFinance credit ratings and rating scales

10. modeFinance produces one type of credit ratings, namely Corporate credit ratings shown in Column 2 of Figure 2 in Appendix 1. This rating may be used by institutions for the calculation of risk weights under the Standardised Approach (SA)[6].

11. modeFinance assigns corporate credit ratings to financial and non-financial companies. The assigned rating represents the opinion of the rating agency on the entity's creditworthiness across a risk horizon of 10 years.

12. modeFinance assigns this credit rating to the Global long-term rating scale, as illustrated in column 3 of Figure 2 in Appendix 1. The rating scale is described in Figure 3 of Appendix 1.

13. A specific mapping has been produced for the Global long-term credit rating scale, as explained in Section 4, which has been derived in accordance with the quantitative and qualitative factors specified in the Implementing Regulation.

4. Mapping of modeFinance's Global long-term rating scale

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[3] The mapping does not contain any assessment of the registration process of modeFinance carried out by ESMA.

[4] These statistics are computed from individual rating information provided by registered or certified Credit Rating Agencies to ESMA, as required as per Article 11(2) of the CRA Regulation. http://cerep.esma.europa.eu/cerep-web/

[5] The last reporting period for which data are available in CEREP is the second semester of 2015.

[6] Article 4(1) CRA allows the use of the credit assessments for regulatory purposes as long as they meet the definition of credit rating as per Article 3(1)(a) of the CRA Regulation.

14. The mapping of the Global long-term rating scale consisted of two different stages, where quantitative and qualitative factors were considered.

15. In the first stage, the quantitative factors referred to in Article 1 of the Implementing Regulation 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 Implementing Regulation, as a sufficient number of credit ratings is not available.

16. In a second stage, the qualitative factors proposed in Article 7 of the Implementing Regulation have been considered to challenge the initial mapping produced in the previous stage.

4.1. Initial mapping based on the quantitative factors

4.1.1. Calculation of the long-run default rate

17. CEREP did not reflect information regarding the credit ratings issued by modeFinance. Therefore the allocation of Credit Quality Steps (CQS) has been made in accordance with Article 6 of the Implementing Regulation, as shown in Figure 4 of Appendix 3.

18. For rating category "D", default rates were not calculated 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 CQS was initially made in accordance with Article 6 of the Implementing Regulation. 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.

- **A1/A2/A3/B1/B2/B3:** 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 steps associated with the A1/A2, A3, B1, B2, B3 rating categories in the international rating scale (CQS 1, CQS 2, CQS 3, CQS 4 and CQS 5 respectively) can be assigned.

- **C1/C2/C3:** 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.

20. The calculation of the number of items assigned the same rating category weights withdrawn ratings by 50% as indicated in Article 4(3) of the Implementing Regulation.

21. The definition of default has been taken into account for the calculation of the quantitative factors, following Article 8 of the Implementing Regulation.

4.2. Final mapping after review of the qualitative factors

22. The qualitative factors specified in Article 7 of the Implementing Regulation have been used to challenge the mapping proposed by the default rate calculation. Qualitative factors acquire more importance for rating categories where quantitative evidence is not sufficient to test the default behavior[7], as it is the case for all modeFinance's rating categories.

23. The **definition of default** applied by modeFinance 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 events (a), (b), (c) and (d) of the benchmark definition of default specified in Article 4(4) of the Implementing Regulation.

    - As modeFinance does not have any default recorded, there is no information on the share of bankruptcy-related default events.

    No change is proposed to the mapping based on this factor.

24. The mapping proposal resulting from the quantitative factors complies with the qualitative criteria on the **meaning and relative position** of a rating category, as specified in Article 10 of the Implementing Regulation.

25. Regarding the **time horizon**, modeFinance's rating methodology focuses on the long-term (10 years). However, the stability cannot be assessed given the lack of data. No adjustment is proposed based on this factor.

26. 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 rating categories under Article 6 of the Implementing Regulation.

27. Regarding the estimate provided by modeFinance of the long-term default rate associated with all items assigned the same rating category, according to Article 12 of the Implementing Regulation, it should be taken into account for the purpose of the mapping as long as it has been adequately justified. However, due to the scarce quantitative data and caveats related to the estimation (based on the use of scores), this factor has not been further used to adjust the mapping.

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[7] The default behavior of a rating category is considered to be properly tested if a sufficient number of credit ratings is available, i.e. the quantitative factors for that rating category are calculated under Articles 3 – 5 of the Implementing Regulation.

Appendix 1: Credit ratings and rating scales

Figure 2: Relevant credit rating and rating scale

SA exposure class	Name of credit rating	Credit rating scale
Long-term rating		
Corporates	Corporate credit rating	Global long-term rating scale

Source: modeFinance

Figure 3: Global long-term rating scale

Credit assessment	Meaning of the credit assessment
A1	Excellent company with sound reliability and extreme ability of repaying financial obligations
A2	Very good company with very good capability of repaying financial obligations
A3	Good company with good capability of repaying financial obligations. Very low dependence on possible adverse macroeconomic conditions
B1	Average company with average capability of repaying financial obligations. Possible adverse macroeconomic conditions or changes in management or in strategies might impact on the capability of repaying debt
B2	Average company with only enough capability of repaying financial obligations. Possible adverse macroeconomic conditions or changes in management or in strategies might impact on the capability of repaying debt
B3	Average to instable company with low capability of repaying financial obligations. Vulnerable to B3 possible adverse macroeconomic conditions or changes in management or in strategies
C1	Instable company with low capability of repaying financial obligations. Very vulnerable to possible adverse macroeconomic conditions or changes in management or in strategies
C2	Poor company with insufficient capability of repaying financial obligations. Company that needs financial restructuring in order to ensure operational continuity
C3	Poor company with insufficient capability of repaying financial obligations. Company that needs financial and debts restructuring with capital injection in order to ensure operational continuity
D	In default

Source: modeFinance

Appendix 2: Definition of default

modeFinance defines default as occurring if:

- Missed payments on financial obligation are officially recorded

- The rated entity is under liquidation or bankruptcy status

- The rated entity is under administration

Source: modeFinance

Appendix 3: Default rates of each rating category

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

	A1/A2	A3	B1	B2	B3	C1/C2/C3
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: JC calculations based on CEREP data.

Appendix 4: Mappings of each rating scale

Figure 5: Mapping of modeFinance's global long-term rating scale

Credit assessment	Initial mapping *based on quantitave factors* (CQS)	Final review *based on qualitative factors* (CQS)	Main reason for the mapping
A1	1	1	The quantitative factors are representative of the final CQS.
A2	1	1	
A3	2	2	The quantitative factors representative of the final CQS.
B1	3	3	The quantitative factors are representative of the final CQS.
B2	4	4	The quantitative factors are representative of the final CQS.
B3	5	5	The quantitative factors are representative of the final CQS.
C1	6	6	The quantitative factors are representative of the final CQS.
C2	6	6	
C3	6	6	
D	6	6	The meaning and relative position of the rating category is representative of the final CQS