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PRESS RELEASE

The performance of credit rating systems in the assessment of collateral used in Eurosystem monetary policy operations

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The Working Paper "The performance of credit rating systems in the assessment of collateral used in Eurosystem monetary policy operations", is also published in the Occasional Paper Series of the ECB within the context of the so-called Eurosystem Credit Assessment Framework (ECAF).

The ECAF constitutes the techniques and rules which establish and ensure the Eurosystem´s requirement of high credit standards for all eligible collateral. Within this framework, the Eurosystem has specified its understanding of high credit standards at a minimum credit quality of a rating equivalent to "A" as issued by the major international rating agencies.

The aims of this paper are twofold: first, the authors attempt to express the threshold of a single "A" rating in terms of annualized probabilities of default. We use data from Standard & Poor's and Moody's publicly available rating histories to construct confidence intervals for the level of probability of default to be associated with the single "A" rating. The second aim is to review various existing validation models for the probability of default which enable the analyst to check credit assessment systems' forecasting ability of future default events. Within this context the paper proposes a simple mechanism for the comparison of the performance of major rating agencies and that of other credit assessment systems such as Internal Rating Based systems of commercial banks under the Basle II regime. This is done to provide a simple validation yardstick to help in the monitoring of the performance of the different credit assessment systems participating in the assessment of eligible collateral underlying Eurosystem monetary policy operations. Contrary to the widely used confidence interval approach, the proposal of the authors, based on an interpretation of p-values as frequencies, claims to guarantee a convergence to an ex ante fixed probability of default (PD) value. Given the general characteristics of the problem considered, they regard this simple mechanism applicable also in other contexts.