

EUROSYSTEM CREDIT ASSESSMENT FRAMEWORK FOR MONETARY POLICY OPERATIONS

The Eurosystem Credit Assessment Framework (ECAF) is an important element in mitigating financial risks for the Eurosystem. The Eurosystem conducts its regular liquidity-providing monetary policy operations as reverse transactions (repurchase agreements and collateralised loans) which must be secured by adequate collateral.¹ The ECAF is key to ensuring that the Eurosystem's requirement of high credit standards for all assets that are eligible for use as collateral in Eurosystem monetary policy operations is met.²

The ECAF defines the procedures, rules and techniques which ensure that the Eurosystem accepts only assets with high credit standards as collateral. The main elements of the ECAF are:

- (i) the collection of credit quality information from a variety of sources;
- (ii) the definition of a harmonised minimum credit quality assessment;
- (iii) due diligence on the different credit assessment systems used in the ECAF.

This box explains how the ECAF contributes to risk mitigation in the Eurosystem's collateral framework and how the Eurosystem conducts due diligence within the ECAF. The box concludes with an overview of recent decisions taken by the Governing Council of the ECB aimed at enhancing ECAF due diligence.

Risk mitigation and the ECAF

Since the Eurosystem accepts a very broad range of marketable and non-marketable assets as collateral,³ it has to rely on various sources of credit assessment information. The Eurosystem therefore takes into account information derived from four types of credit assessment systems⁴:

- credit rating agencies, known as external credit assessment institutions (ECAIs);
- in-house credit assessment systems (ICASs) of NCBs;
- counterparties' internal ratings-based (IRB) systems;
- rating tools (RTs) provided by third parties.

1 See Article 18.1 of the Statute of the European System of Central Banks and of the European Central Bank.

2 The Eurosystem uses several layers of protection against financial risks from its monetary policy operations. First, banks participating in Eurosystem monetary policy operations must be financially sound. Second, the statutory requirement of adequate collateral mitigates financial risks for the Eurosystem in the case of a counterparty default; it is implemented using three main pillars: the eligibility criteria established in accordance with the ECAF, the appropriate valuation of collateral and the application of risk control measures, such as valuation haircuts. For more information about Eurosystem financial risk mitigation, see: (i) the dedicated section of the ECB's website (<http://www.ecb.europa.eu/mopo/assets/risk/html/index.en.html>); (ii) the article entitled "Risk mitigation methods in Eurosystem credit operations", *Monthly Bulletin*, ECB, May 2004; (iii) the article entitled "The Eurosystem collateral framework throughout the crisis", *Monthly Bulletin*, ECB, July 2013; and (iv) Guideline ECB/2011/14 on monetary policy instruments and procedures of the Eurosystem, often referred to as the "General Documentation", and amendments thereof.

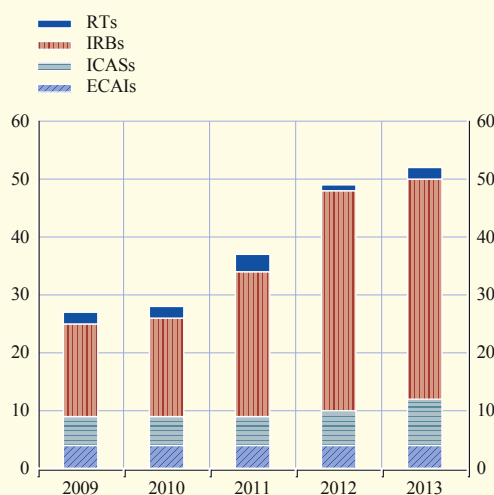
3 In December 2011 the ECB's Governing Council introduced the possibility for NCBs to accept as collateral additional performing credit claims (i.e. bank loans) that satisfy specific eligibility criteria. This temporary solution was introduced to support bank lending and liquidity in the euro area money market. As part of the related harmonised criteria, the requirements for reporting and monitoring under the ECAF are applied to all credit assessment systems used to assess the credit quality of credit claims accepted under the national frameworks for such additional credit claims.

4 Additionally, the Eurosystem can take into account institutional criteria and features that guarantee similar protection for the instrument holder.

ECAIs are mainly used for assessing marketable collateral, whereas ICASs, IRB systems and RTs are mainly used for non-marketable collateral.

At the end of 2011 the Governing Council announced that the Eurosystem would work towards enhancing its internal credit assessment capabilities, and encouraged providers of RTs and counterparties using IRB systems to seek Eurosystem endorsement under the ECAF.⁵ As a result, two years later, the number of ICASs had increased by 60%, and the number of counterparties with an ECAF-approved IRB had increased by more than 50%. More NCBs are analysing the business case for introducing ICASs. It is also expected that the number of ECAF-approved IRB systems will continue to grow.

Number of credit assessment systems in the ECAF



Source: ECB.

An important contribution of the ECAF is to bring together the information provided by this significant number of credit assessment systems in a harmonised way. The ECAF makes the credit ratings from all ECAF-accepted credit assessment systems comparable by mapping each of their rating grades to the appropriate credit quality step of the Eurosystem's harmonised rating scale (see the table on the next page for the mapping of ECAI rating grades).

Harmonised credit quality information about collateral assets fosters Eurosystem financial risk mitigation in at least two ways: first, the ECB's Governing Council has set credit quality step 3 of this scale as being the minimum requirement for high credit standards in the ECAF, and thus for the eligibility as collateral.⁶ Second, the Eurosystem applies greater valuation haircuts to lower credit quality assets, aiming at risk equivalence across all eligible assets.

Due diligence in the ECAF

The Eurosystem has established a number of regulatory, operational and information requirements for ECAF-acceptance of credit assessment systems. These aim at protecting the Eurosystem from financial risks and creating a level playing field between the different systems that provide credit assessment information to the Eurosystem, while taking particular account of the respective regulatory situation. For example, to be considered for ECAF purposes, ECAIs need to be supervised by the European Securities and Markets Authority (ESMA), and IRB systems have to be authorised for capital requirements purposes by the relevant banking supervisor. The ECB's Governing Council approves ICASs and RTs for the ECAF on the basis of an assessment, prepared by the ECB's risk management function, against acceptance criteria that are similar to those applied by ESMA for ECAIs, and by banking supervisors for IRB systems.

⁵ See the ECB press release "ECB announces measures to support bank lending and money market activity", 8 December 2011.

⁶ Credit quality step 3 is considered equivalent to a probability of default of between 0.10% and 0.40% over a one-year horizon.

In addition to the acceptance criteria, the Eurosystem conducts further due diligence on all credit assessment systems accepted in the ECAF. The key tool for regular ECAF due diligence is known as “annual performance monitoring”. It consists of:

- (i) a statistical component, to check if the mapping of the ratings of each credit assessment system to the Eurosystem’s harmonised rating scale remains appropriate;⁷
- (ii) a qualitative component, which looks at credit assessment processes and methodologies, as well as taking into account supervisory information.

The ECAF provides the Eurosystem with a set of tools to prevent mechanistic reliance on any system and to address issues that have been identified with a specific system. The first element of this set of tools is a more intensive monitoring in cooperation with the provider of the credit assessment system, including an investigation to determine if and how the performance issues are being addressed. In addition, the ECB’s Governing Council can: (i) remap a system’s rating grades onto the Eurosystem’s harmonised rating scale; (ii) define specific eligibility requirements related to credit assessment systems; (iii) apply discretionary measures; and (iv) even exclude or temporarily suspend a credit assessment system. For example, the Governing Council has stipulated that ECAs must publish, on a regular basis, surveillance reports for asset-backed securities and has decided on the suspension (subject to specific conditions) of the credit quality threshold for debt instruments issued by certain euro area governments.

Recent Governing Council decisions relating to the ECAF

The ECB’s Governing Council considered the results of the ECAF’s annual performance monitoring exercise for 2012 and concluded that the performance of ECAF-approved credit assessment systems was, overall, satisfactory. On the basis of this assessment, the Governing Council decided in 2013 to revise the mapping of certain ratings of some credit assessment systems onto the Eurosystem’s harmonised rating scale. Where necessary, these decisions were implemented in the relevant legal acts.⁸ In particular, some short-term rating grades have been re-mapped,

Eurosystem harmonised rating scale for ECAs

ECAI credit assessment		Credit quality step (CQS)		
		CQS 1	CQS 2	CQS 3
Short-term	DBRS		R-1H, R-1M	R-1L, R-2H, R-2M, R2-L
	Fitch Ratings		F1+, F1	F2
	Moody’s		P-1	P-2
	Standard & Poor’s		A-1+, A-1	A-2
Long-term	DBRS	AAA/AAH/AA/AAL	AH/A/AL	BBBH/BBB/BBBL
	Fitch Ratings	AAA/AA+/AA/AA-	A+/A/A-	BBB+/BBB/BBB-
	Moody’s	Aaa/Aa1/Aa2/Aa3	A1/A2/A3	Baa1/Baa2/Baa3
	Standard & Poor’s	AAA/AA+/AA/AA-	A+/A/A-	BBB+/BBB/BBB-

7 The procedure is based on methodologies described in Coppens, F., González, F. and Winkler, G., “The performance of credit rating systems in the assessment of collateral used in Eurosystem monetary policy operations”, *Occasional Paper Series*, No 65, ECB, Frankfurt am Main, July 2007.

8 These legal acts are: (i) Guideline ECB/2014/10 amending Guideline ECB/2011/14 on monetary policy instruments and procedures of the Eurosystem, i.e. the “General Documentation”; and (ii) Guideline ECB/2014/12 amending Guideline ECB/2013/4 on additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral. For further information, see the document entitled “Decisions taken by the Governing Council of the ECB (in addition to decisions setting interest rates) in March 2014”, which is published on the ECB’s website.

primarily to ensure consistency with the long-term rating scale of the respective rating agency, and the “BBBL”-rating grade of the rating agency “DBRS” has been included in credit quality step 3. The table presents the current Eurosystem harmonised rating scale for ECAs.

To further enhance ECAF due diligence, the Governing Council also decided to:

- (i) strengthen the monitoring framework for IRBs;
- (ii) approve a detailed set of principles for overseeing ICASs;
- (iii) improve on the due diligence conducted on ECAs’ ratings, rating processes and methodologies, particularly in the areas of sovereign ratings and structured finance.

This enhancement of due diligence is a step towards further reducing the Eurosystem’s reliance on ECAs, in line with various initiatives by international public authorities aimed at reducing reliance on ECAs in legal, regulatory and other public frameworks.⁹

⁹ See, for example, the roadmap for reducing reliance on credit rating agencies’ ratings, as published by the G20’s Financial Stability Board, together with the provisions of Regulation (EU) No 462/2013 of the European Parliament and of the Council on credit rating agencies (known as the “CRA III Regulation”), which aim to reduce over-reliance on credit rating agencies’ ratings, in particular by reducing sole or mechanistic reliance on such ratings.