MANUAL ON INTERNAL ESCB PROCEDURES
FOR THE MONETARY POLICY FRAMEWORK
IN STAGE THREE OF EMU

23 November 1998
THE MINIMUM CREDIT RATING STANDARD FOR ELIGIBLE ASSETS

In the assessment of the financial soundness of eligible assets, the ESCB applies the harmonised rating scale presented in Table 1. The minimum credit standard is set at step 3 of the harmonised rating scale. For the update of records in the ECB’s database on eligible assets, step 4 of the harmonised rating scale is applied.

<table>
<thead>
<tr>
<th>Harmonised rating scale</th>
<th>Short-term rating</th>
<th>Long-term rating</th>
<th>Financial strength or individual rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Standard&amp;Poor’s: A-1+ IBCA: F1+</td>
<td>Standard&amp;Poor’s: AAA Standard&amp;Poor’s ADEF: AAA Moody’s: Aa IBCA: AAA</td>
<td>Moody’s: A IBCA: A</td>
</tr>
</tbody>
</table>

This harmonised rating scale is based on the definitions applied by the three main international market rating agencies, namely Moody’s, Standard & Poor’s and IBCA which are described in more detail in the following sections. The main types of ratings referred to by these agencies are summarised in Table 2.

Table 2. Types of ratings used by market credit rating agencies

<table>
<thead>
<tr>
<th></th>
<th>Moody’s</th>
<th>Standard&amp;Poor’s</th>
<th>IBCA</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Short term</td>
<td>Long term</td>
<td>Financial strength</td>
</tr>
<tr>
<td></td>
<td>issuer</td>
<td>issue</td>
<td>bank</td>
</tr>
<tr>
<td>Short term assets</td>
<td>Yes²</td>
<td>Yes²</td>
<td></td>
</tr>
<tr>
<td>Long term assets</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Central government as guarantor</td>
<td>Yes³</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank as guarantor</td>
<td>Yes³</td>
<td>Yes³</td>
<td></td>
</tr>
</tbody>
</table>

1 The terms used in the Table are explained in the text
2 For senior debt instruments only
3 For unsecured debt instruments only
1. Moody’s

Short-Term Debt Ratings
Moody’s short-term ratings, unlike the long-term ratings, apply to an individual issuer’s capacity to repay all short-term obligations rather than to specific short-term borrowing programs. Once assigned to an issuer, a short-term rating is global in scope; it applies to all the issuer’s senior, unsecured obligations with an original maturity of less than one year regardless of the currency or market in which the obligations are issued. Moody’s employs the following three designations, all judged to be investment grade, to indicate the relative repayment ability of rated issuers:

- **Prime-1**: Issuers rated Prime-1 (or supporting institutions) have a superior ability for repayment of senior short-term debt obligations (leading market position; high rates of return; conservative capitalisation structure; broad margins in earnings coverage of fixed financial charges and high internal cash generation; well-established access to a range of financial markets and assured sources of alternate liquidity).

- **Prime-2**: Issuers rated Prime-2 (or supporting institutions) have a strong ability for repayment of senior short-term debt obligations. Earning trends and coverage ratios, while sound, may be more subject to variation than P-1. Capitalisation characteristics, while still appropriate, may be more affected by external conditions.

- **Prime-3**: Issuers rated Prime-3 (or supporting institutions) have an acceptable ability for repayment of senior short-term obligations. The effect of industry characteristics and market compositions may be more pronounced. Variability in earnings and profitability may result in changes in the level of debt protection measurements and may require relatively high financial leverage.

- **Not Prime**: Issuers rated Not Prime do not fall within any of the Prime rating categories.

Long-Term Debt Ratings
Moody’s long-term debt ratings are assigned to specific debt instruments (such as bonds and debentures) and reflect Moody’s assessment of 1) credit risk - the future ability of an issuer to repay its long-term debt obligations; and 2) indenture protection - the level of legal protection afforded to the holder of a specific security based on that security’s indenture provisions relating to senior/subordinated status, security, negative pledge clauses, guarantees etc. An issuer’s senior unsecured debt rating may be regarded as an indication of the issuer’s overall credit quality, but investors are advised to confirm ratings of specific securities they consider purchasing, because securities issued by a single issuer may carry different ratings due to different indenture provisions.

- **Aaa**: Bonds which are rated Aaa are judged to be of the best quality. They carry the smallest degree of investment risk and are generally referred to as “gilt-edged”. Interest payments are protected by a large or by an exceptionally stable margin and principle is secure.

- **Aa**: Bonds which are rated Aa are judged to be of high quality by all standards. Together with the Aaa group they comprise what are generally known as high grade bonds. They are rated lower than the best bonds because margins of protection may not be as large as in Aaa securities or fluctuations of protective elements may be of greater amplitude or there may be other elements present which make the long-term risk appear somewhat larger than the Aaa securities.

- **A**: Bonds which are rated A possess many favourable investment attributes and are to be considered as upper-medium-grade obligations. Factors giving security to principle and interest are considered adequate, but elements may be present which suggest a susceptibility to impairment some time in the future.

- **Baa**: Bonds which are rated Baa are considered as medium-grade obligations (i.e. they are neither highly protected nor poorly secured). Interest and principal security appear adequate for the present
but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and in fact have speculative characteristics as well.

Many entities may have more than one issue of long-term debt. The long-term debt rating shown in the Global Ratings Guide is the highest long-term debt rating assigned by Moody’s to that entity’s debt.

**Bank Financial Strength Ratings**

Moody’s Bank Financial Strength Ratings represent Moody’s opinion of a bank’s intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody’s traditional debt and deposit ratings. Unlike Moody’s traditional debt ratings, Bank Financial Strength Ratings do not address the probability of timely payment. Instead, Bank Financial Strength Ratings can be understood as a measure of the likelihood that a bank will require assistance from third parties such as its owners, its industry group, or official institutions. Bank Financial Strength Ratings do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank’s ability to honour its domestic or foreign currency obligations.

Factors considered in the assignment of Bank Financial Strength Ratings include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although bank Financial Strength Ratings exclude the external factors specified above, they do take into account other risk factors in the bank’s operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision. The financial strength rating is defined as follows:

- **A**: Banks rated A possess exceptional intrinsic financial strength. Typically, they will be major institutions with highly valuable and defensible business franchises, strong financial fundamentals, and a very attractive and stable operating environment.

- **B**: Banks rated B possess strong intrinsic financial strength. Typically, they will be important institutions with valuable and defensible business franchises, good financial fundamentals, and an attractive and stable operating environment.

- **C**: Banks rated C possess good intrinsic financial strength. Typically, they will be institutions with valuable and defensible business franchises. These banks will demonstrate either acceptable financial fundamentals within a stable operating environment, or better than average financial fundamentals within an unstable operating environment.

- **D**: Banks rated D possess adequate financial strength, but may be limited by one or more of the following factors: a vulnerable or developing business franchise; weak financial fundamentals; or an unstable operating environment.

**2(a) Standard & Poor’s**

**Issue Credit Rating**

Standard & Poor’s issue credit rating is a current opinion of the creditworthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program. It takes into consideration the creditworthiness of guarantors, insurers, or other forms of credit enhancement on the obligation and takes into account the currency in which the obligation is denominated. Issue credit ratings are based on the following considerations: 1) likelihood of payment, 2) nature of and provisions of the obligation, 3) protection afforded by and relative position of
the obligation in the event of bankruptcy, reorganisation, or other arrangement under the laws of bankruptcy and other laws affecting creditor’s rights.

The issue credit rating definitions are expressed in terms of default risk. As such, they pertain to senior obligations of an entity. Junior obligations are typically rated lower than senior obligations. Accordingly, in the case of junior debt, the rating may not conform exactly with the category definition.

**Long-Term Issue Credit Ratings**
- **AAA**: An obligation rated AAA has the highest rating assigned by Standard & Poor’s. The obligor’s capacity to meet its financial commitment on the obligation is extremely strong.
- **AA**: An obligation rated AA differs from the highest rated obligations only in small degree. The obligor’s capacity to meet its financial commitment on the obligation is very strong.
- **A**: An obligation rated A is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher rated categories. However, the obligor’s capacity to meet its financial commitment on the obligation is still strong.
- **BBB**: An obligation rated BBB exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.
- **X**: This symbol is attached to the ratings of instruments with significant non-credit risks. It highlights risks to principal or volatility of expected returns which are not addressed in the credit rating. Examples include: obligations linked or indexed to equities, currencies, or commodities; obligations exposed to severe prepayment risk; and obligations with unusually risky interest terms.

**Short-Term Issue Credit Ratings**
- **A-1**: A short-term obligation rated A-1 is rated in the highest category by Standard & Poor’s. The obligor’s capacity to meet its financial commitment on the obligation is strong. Within this category, certain obligations are designated with a plus sign (+). This indicates that that the obligor’s capacity to meet its financial commitment on these obligations is extremely strong.
- **A-2**: A short-term obligation rated A-2 is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher rated categories. However, the obligor’s capacity to meet its financial commitment on the obligation is satisfactory.
- **A-3**: A short-term obligation rated A-3 exhibits adequate protection parameters. However, adverse economic conditions and changing circumstances are more likely to lead to a weakened capacity to meet its financial commitment on the obligation.

**Issuer Credit Rating**
Standard & Poor’s issuer credit rating is a current opinion of the obligor’s overall financial capacity (its creditworthiness) to pay its financial obligations. This opinion focuses on the obligor’s capacity and willingness to meet its financial commitments as they come due. It does not apply to specific financial obligation, as it does not take into account the nature of and provisions of the obligation, its standing in bankruptcy or liquidation, statutory preferences, or the legality and enforceability of the obligation. In addition it does not take into account the creditworthiness of the guarantors, insurers, or other forms of credit enhancement on the obligation. Short-Term Issuer Credit Ratings reflect the obligor’s creditworthiness over a short-term time horizon.
Long-Term Issuer Credit Ratings

- **AAA**: An obligor rated AAA has extremely strong capacity to meet its financial commitments.
- **AA**: An obligor rated AA has very strong capacity to meet its financial commitments.
- **A**: An obligor rated A has strong capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in higher rated categories.
- **BBB**: An obligor rated BBB has adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments.

Short-Term Issuer Credit Ratings

- **A-1**: An obligor rated A-1 is rated in the highest category by Standard & Poor’s. The obligor’s capacity to meet its financial commitment on the obligation is strong. Within this category, certain obligors are designated with a plus sign (+). This indicates that the obligor’s capacity to meet its financial commitments is extremely strong.
- **A-2**: An obligor rated A-2 is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in the highest rating category. However, the obligor’s capacity to meet its financial commitments is satisfactory.
- **A-3**: An obligor rated A-3 has adequate capacity to meet its financial commitments. However, adverse economic conditions and changing circumstances are more likely to lead to a weakened capacity to meet its financial commitments.

2(b) Standard & Poor’s ADEF

Issue Credit Rating

Standard & Poor’s provide ratings for domestic market obligations of French issuers on both the traditional Standard & Poor’s rating scale and the ADEF scale. The ADEF scale is compiled according to the same basic methodology as the traditional Standard & Poor’s rating scale. The scales are calibrated to help investors and other rating users to discriminate among domestic market issuers. Nevertheless, the rating of individual issues may differ between the ADEF scale and the traditional Standard & Poor’s rating scale.

Long-Term Issue Credit Ratings

- **AAA**: An obligation rated AAA has the highest rating assigned by Standard & Poor’s ADEF. It implies that the issuer shows an excellent capacity to service and repay debt.
- **AA**: An obligation where the issuer shows an excellent capacity to service and repay debt (but to a lesser degree than for rating AAA).
- **A**: An obligation where the issuer normally has a strong capacity to service and repay debt but vulnerability to the external environment and to technical changes.
- **BBB**: An obligation rated BBB shows that the issuers capacity to service and repay debt is normally still satisfactory, but risks increase if conditions become adverse.

Short-Term Issue Credit Ratings

- **T1**: An obligation rated T1 has the highest rating assigned by Standard & Poor’s ADEF. The debt offers a high level of security of repayment at maturity.
- **T2**: The debt is vulnerable to changes in the economic environment and therefore includes a certain speculative element.
2(c) Standard & Poor’s Nordic

Issue Credit Rating
Standard & Poor’s provide ratings for domestic market obligations of issuers in Finland and Sweden on both the traditional Standard & Poor’s rating scale and the Nordic scale. The Nordic scale refers only to short term obligations and is compiled according to the same basic methodology as the traditional Standard & Poor’s short-term issue credit rating scale. The two scales are calibrated to help investors and other rating users to discriminate among domestic market issuers. Nevertheless, the rating of individual issues may differ between the Nordic scale and the traditional Standard & Poor’s short-term issue credit rating scale.

Short-Term Issue Credit Ratings
- **K-1**: An obligation rated K-1 has the highest rating assigned by Standard & Poor’s Nordic. An issuer of commercial paper assigned to this category is regarded as having a very good capacity for timely repayment of rated debt. Cash flow and liquidity are more than satisfactory to meet predictable demands in the foreseeable future.
- **K-2**: An obligation rated K-2 is considered to have a high creditworthiness. An issuer of commercial paper assigned to this category is regarded as having a good capacity for timely repayment of rated debt. Cash flow and liquidity are satisfactory to meet predictable demands in the foreseeable future.
- **K-3**: An obligation rated K-3 is considered to have an adequate creditworthiness. An issuer of commercial paper assigned to this category is regarded as having an adequate capacity for timely repayment of rated debt. Cash flow and liquidity are sufficient to meet predictable demands in the foreseeable future.

3. IBCA
The IBCA rating system provides an assessment of a bank from two viewpoints: in addition to Legal and Individual ratings, short- and long-term ratings for both issuers and issues are provided. In the case on non-banks only short- and long-term ratings, again for both issuers and issues, are provided. When applied to an issuer, these short- and long-term ratings refer to its creditworthiness on a senior, unsecured basis. When applied to specified issues and programmes, these ratings take into account the position of the holder of the debt security issued and reflect the terms, conditions and covenants attaching to that security.

Long-term ratings
- **AAA**: Capacity for timely repayment of principal and interest is substantial, such that adverse changes in business, economic or financial conditions are unlikely to increase investment risk substantially.
- **AA**: Capacity for timely repayment of principal and interest is substantial. Adverse changes in business, economic or financial conditions may increase investment risk, albeit not very significantly.
- **A**: Capacity for timely repayment of principal and interest is strong, although adverse changes in business, economic or financial conditions may lead to increased investment risk.
- **BBB**: Capacity for timely repayment of principal and interest is adequate, although adverse changes in business, economic or financial conditions are more likely to lead to increased investment risk than for obligations in other categories.
Short-term ratings
- **F1**: Obligations supported by the highest capacity for timely repayment. Where issues possess a particularly strong credit feature, a rating of F1+ is assigned.
- **F2**: Obligations supported by a satisfactory capacity for timely repayment, but the margin of safety is not as great as in the case of higher ratings.
- **F3**: Obligations supported by an adequate capacity for timely repayment, however, near-term adverse changes could result in a reduction to non-investment grade.

Individual performance rating
For reasons of prudence, IBCA considers its Legal Ratings as not sufficient in itself. If a bank runs into difficulties, it is certainly possible, even if it has a state guarantee, that its marketable obligations might fall to a discount. Banks would be judged on their economic merits and not on the likelihood of being able to get external support. IBCA’s Individual Ratings attempt to answer the question: “If the bank were entirely independent and could not rely on support from the state authorities or its owners, how would it be viewed?” Thus, IBCA’s individual bank rating permits an evaluation of banks divorced entirely from consideration of support. The Individual Ratings are defined as follows:
- **A**: A bank of impeccable financial condition, with a consistent record of above average performance.
- **B**: A bank with sound credit profile and without significant problems. The bank’s performance has generally been in line with or better than that of its peers.
- **C**: A bank which has an adequate credit profile but possesses one or more troublesome aspects, giving rise to the modest possibility of risk developing, or which has generally failed to perform in line with its peers.
- **D**: A bank which is currently underperforming in some notable manner. Its financial condition is likely to be below average and its profitability poor. The bank has the capacity of recovering from its own resources but this is likely to take some time.