

Pitfalls and Remedies in Testing the Calibration Quality of Rating Systems

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Abstract

Testing calibration quality by means of backtesting is an integral part in the validation of credit rating systems. Against this background this paper provides a comprehensive overview of existing testing procedures. We study the procedures' deficiencies theoretically and illustrate their impact empirically. Based on the insights gained thereof, we develop enhanced hybrid testing procedures which turn out to be superior to the commonly applied methods. We also propose computationally efficient algorithms for our calibration tests. Finally, we are able to demonstrate empirically that our method outperforms existing tests in a scenario analysis using rating data of Moody's.

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