

Quo Vadis, Raters? A Frontier Approach to Identify Misratings in Sovereign Credit Risk

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Abstract

This study analyzes misratings in sovereign credit risk. The analysis uses partial frontier methods, a technique barely applied in this literature. By combining a robust variant of the Free Disposal Hull (FDH) estimator, we measure misratings (both underratings and overratings) for individual countries and groups of countries. Particular attention is paid to comparing pre-crisis and crisis years in order to assess possible changes in the magnitude of the misratings. Our findings indicate a remarkable degree of both overratings and underratings during the analyzed period (1999-2010). These misratings partially vanish during the last years of the sample (2008-2010)—corresponding to the financial crisis—when many downgrades took place, especially in Eurozone countries. The results allow us to emphasize the importance of monitoring misratings for sustainable financial stability. These results also show the potential benefits of using partial frontier methods for measuring both underratings and overratings.

Keywords: credit rating agency, partial frontier, rating, sovereign credit risk.

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