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*In light of the recent massive sovereign countries’ and banks’ rating downgrades, Dukascopy TV has interviewed and asked opinions on the role and importance of rating agencies of two experts - **Prof. Dr Norman Schürhoff**, Professor of Finance at University of Lausanne, Senior Chair at Swiss Finance Institute and Research Affiliate at the Center for Economic Policy Research (CEPR) and **Prof. Dr Christian Ewerhart**, Chair for Information Economics and Contract Theory at University of Zurich and a former consultant to ECB and Banque de France.*



Prof. Dr Norman Schürhoff



Prof. Dr Christian Ewerhart

**1) A common society perception is that rating Agencies have overlooked the financial crisis of 2008. Do you think that their current abnormal activity is an attempt to make up for past mistakes? Or they are just fairly doing their job?**

**N.S.:** To my mind, it looks like they take their job seriously. Rating agencies play an important economic role. They try to make an assessment of what is the solvency of a company or, respectively, a country. This is an inherently difficult task. Many investors rely on them, because of the ratings' information content and because many regulations (still) rely on ratings. Keeping a good reputation is therefore essential for rating agencies. My own research shows that rating labels, such as "investment grade" and "junk", matter for asset prices beyond the ratings' informational content. Of course, politicians have their own constituents. Facing the truth about what is the state of solvency can sometimes be hard. But this is exactly the role of rating agencies; they form a view about the solvency of a company or country.

**C.E.:** Rating agencies are indeed in a difficult position these days. It almost seems the industry is trying to regain reputation at all costs. For example, rating agencies are now perceived to be more political than before the crisis. I am personally not sure that this is the best route for them to follow.

**2) There are more and more pronounced attempts to regulate rating agencies. Do you think it is necessary? What is your recipe for effective regulation of rating agencies?**

**N.S.:** During the financial crisis we have seen that ratings assigned by ratings agencies were not accurately reflecting the risk of some types of securities. The market for ratings is regulated, with only ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs) permitted for regulatory purposes. As there are only three large NRSROs, it seems evident that someone should ensure rating agencies cannot exploit market power. However, there is no consensus in academia about the optimal way of regulation and whether the issuer or the investor should pay for the rating. Another challenge is that it is hard to verify if what they recommend is true or false. After all, they are producing very specific intangible goods – knowledge.

**C.E.:** This is tough issue, of course. But yes, I think rating agencies should be regulated. Above all, the ratings themselves must become more transparent. That is to say, the data basis and methods for determining a rating must be simplified, so that these details can be communicated along with the results. If such simplification is not possible, then the rating cannot be objective and should be treated in a different way. More transparency would also help to shift responsibility from rating agencies to where it really belongs, namely to the investors.

**3) We have seen some unprecedented downgrades so far lead by US that lost its AAA rating from S&P. Do you agree that the world has officially lost its risk-free benchmark and the financial theory is not working anymore?**

**N.S.:** I am not sure about this conclusion – we have seen a downgrade that reflects the deterioration of the US financial situation, but still a US default is hard to imagine. This could happen when Republicans and Democrats do not agree on the budget – which is something we have seen during the summer. Meanwhile, a last resort for a country is to print money. The US could print more money, but it is not clear if they would have to default on their payments. In any case, I do not think we have lost a risk-free benchmark as the market's reaction to the US rating's downgrade was such that the yields on US debt went down; this was good news for US Treasury bonds.

**C.E.:** Financial economics does not pre-suppose the existence of a risk-free asset. Thus, I do not see why theory should have stopped working. But there is indeed a challenge. The crisis has shown the possibility that liquidity evaporates from certain markets quite suddenly. We do not have yet the right models to capture this sort of development. On the other hand, such models are needed by both regulators and market participants.