
CONFERENCES AND REPORTS

Conference on Formation of the rating from the viewpoint of banks and rating agencies

On March 1, 2012 a conference on the topic “Formation of the rating (from the viewpoint of banks and rating agencies)” has been held at the Faculty of Law of the Charles University. The conference has been organized by the Department of National Economy.

The key speakers were **Ing. Martin Kupka, CSc.** (main economist of Československá obchodní banka), **Ing. Jakub Černý** (head of department of investor relations in Komerční banka, a.s.), **Ing. Petr Vinš, Ph.D.** (Chief Executive Officer of Moody’s Central Europe, a.s.) and **Eva Konradová** (quality co-ordinator of Dun & Bradstreet, s.r.o. belonging to Bisnode group).

Mr. Kupka had a presentation on the topic “Rating and financial crises: blame finding” (Rating a finanční krize: hledání viny). He started with a description of the role of rating agencies in general and specifically in the financial crisis. He pointed out that ratings assigned by the rating agencies are an indication of the risk of default of payment by the issuer. Investors use ratings to purchase securities that fit their risk profile as the level of risk they are willing to accept. The importance of rating is amplified by the complexity of the security whereby investors have difficulty completing their own review. In connection with the financial crisis he highlighted that credit rating agencies have been heavily criticized with respect to the accuracy of their ratings of certain structured financial products. He emphasized three areas of critique: the rating agencies have been faulted for initially assigning too high ratings to those securities; for failing to adjust those ratings sooner as the performance of the underlying assets deteriorated; and for not maintaining appropriate independence from the issuers and underwriters of those securities.

Mr. Kupka also opened the issue of financing rating agencies and its history. In the 1970s, the rating agencies switched their revenue model from “subscriber-pays” to the con-

troversial “issuer-pays”. Since the early 1970s, the largest source of income for the rating agencies is the fees paid by the companies whose financial products are rated. This can tempt rating agencies to rate better than what fundamentals suggest, as many have pointed out during the recent subprime crisis. Before the 1970s, the ratings industry operated under an investor-pays model. Investors subscribed to ratings released by the agencies, and these subscription revenues were the main source of income for the rating agencies. However, owing to the public good nature of ratings and to the increase in free-riding due to the spread of the photocopier machines, rating agencies switched to the current issuer-pays model. Rating agencies operating on an issuer-pays model are suspected to assign more favorable ratings, while rating agencies operating on a subscriber-pays model tend to push ratings down.

Mr. Kupka pointed out that the financial and eurozone crisis has drawn considerable attention to the role of credit rating agencies in the financial system. After the banking collapse in 2008 the rating agencies were criticized for the failure to rate correctly certain financial products, contributing to the severity of the collapse. With their reputations yet to recover, they have now been accused of precipitating and exacerbating the eurozone crisis by downgrading the sovereign ratings of Greece, Ireland and Portugal too far and too fast. Mr. Kupka suggested that easiest and cheapest solution is not to build up a new regulatory agency, but to smartly regulate the existing rating agencies and to abandon the blind belief in the right conclusion on the investor side.

The presentation of the second speaker, Jakub Černý, was called “Bank as an object of rating”. He dealt with two situations in which the bank uses external ratings. Firstly, the bank uses external rating as creditor in relation to the decision-making about allocation of free resources (such as securities, deposits) and to the calculation of capital requirements for ad-

judicating the risk/yield ratio. Secondly, the bank acts as an issuer. Mr. Černý highlighted the role of issuer in relation to the counterparties on the interbank market, to the clients and to the public. Mr. Černý also paid attention to how rating agencies achieve their significant role. As financial markets have grown increasingly complex, borrowing opportunities have expanded dramatically and the ability of a lender to obtain full information about potential borrowers has become ever more difficult. Through economies of scale, rating agencies are able to offer cost-effective information services that narrow the gap between what an investor knows about a borrower and what the borrower knows, assigning each borrower a rating.

The role of rating agencies in financial regulatory frameworks has expanded in recent years, especially as a result of an international agreement to assess bank portfolios based on the risk of their assets and to set capital requirements accordingly. This so-called Basel II Accord sought to add nuance to regulatory standards. A key justification for the incorporation of credit assessments of rating agencies was the belief that they offered a more sophisticated approach to measuring credit risk than did the simpler regulatory practice of basing capital requirements on a fixed percentage of total assets according to the earlier approach.

Mr. Černý also analyzed the regulatory responses of European Union to criticism of regulatory agencies. First set of regulations from September 2010 primarily required rating agencies to be more transparent and open about how they operate. Next set of regulations from November 2011 brought a lot of controversial measures. The European Union plans to expand regulation and change the agency business model. It has proposed much tighter rules affecting accreditation, disclosure requirements, and conflict of interest. Mr. Černý found the most controversial proposed measures to be the requirements for companies (issuers) to change rating agencies every three years.

The next speaker, Petr Vinš, had a presentation on the topic "Moody's rating value and its significance". He introduced Moody's and its long history dated to the year 1914. He described the rating as an independent opinion on the future ability and legal obligation of an issuer

to make timely payments on his financial commitments. Mr. Vinš highlighted that rating implies relative rate of the risk and future ability of the issuer to meet his obligations. He defended the position of rating agencies in the sense that the rating only implies relative rate of the risk and relative rate of future ability of the issuer to meet his obligations.

Mr. Vinš described the rating process which leads to granting of a rating. First phase is preliminary discussion between the potential issuer of debt with the rating agency. It is followed by an analytical meeting with the agency, presentation, questions and answers. Even though rating process can take long time, Mr. Vinš pointed out that it may be accelerated in order to accommodate tighter financing schedules.

He demonstrated the application of Moody's methodologies on the case of ČEZ and Česká spořitelna.

Last speaker, Eva Konradová, dealt with the issue relating to the data mining as an instrument for statistical rating of companies. Data mining involves the use of sophisticated data analysis tools to discover previously unknown, valid patterns and relationships in large data sets. She stressed out that data mining consists of more than collecting and managing data, it also includes analysis and prediction. Ms. Konradová provided as examples of the use of data mining survey of customer information, reduction of fraud and waste and assistance in the presidential election of Barack Obama. The insurance and banking industries use data mining applications to detect fraud and assist in risk assessment (e.g. credit scoring). Using customer data collected over several years, companies can develop models that predict whether a customer has a good credit risk, or whether an accident claim may be fraudulent and should be investigated more closely.

Afterwards there followed a lively discussion mostly about new European regulations and the creation of a European credit rating agency. The topic of the conference was interesting especially due to the fact that the reputational crisis of rating agencies is ongoing and is putting into question whether rating agencies are playing a credible role in the financial system.

Lenka Jurošková

Lecture on the Chinese legal system at the Faculty of Law, Charles University by Mr. Ira Belkin

On the 4th of April 2012, the student association Common Law Society in cooperation with the Ministry of Foreign Affairs of the Czech Republic organized a lecture on Chinese legal system at the Faculty of Law, Charles University. The lecture was given by Mr. Ira Belkin from Ford Foundation in Beijing and saw an abundant participation of students of Faculty of Law, as well as representatives from the professional community. The event was chaired by Professor Michal Tomášek, Head of European law department and legal expert in Far Eastern law. The lecture Mr. Ira Belkin is one of the most qualified speakers on the topic of China's legal system. He has been specializing in Chinese law for many years and published numerous works on this subject. His interest in this area begun with his studies in the U.S., where took up the study of the Chinese language.

During the lecture at the Faculty of Law Mr. Belkin mentioned one of the events that interested him in China in that period. That was a statement of a famous Chinese politician Deng Xiaoping, who, in response to the criticism about his capitalist views, said in 1961: "I don't care if it's a white cat or a black cat. It's a good cat so long as it catches mice." By this sentence Deng Xiaoping ment that it doesn't matter whether the regime is communist or capitalist as long as it works.

Mr. Belkin has always wanted to work in the area of Chinese law, nevertheless he wasn't given this opportunity until the early nineties. At that time business expanded from the U.S. into China and there was a demand for expert knowledge of the Chinese legal system. Therefore he was sent to China, where he could fully utilize his knowledge of Chinese language and his previous experience, gained during study and work.

During the lecture Mr. Belkin also mentioned rapid changes in the Chinese legal system that go hand in hand with cultural reforms. He pointed out that in the more than one-billion Chinese there are currently only about 200 thousand lawyers available and these are concentrated in big cities and coastal

provinces. In criminal cases roughly 20% of defendants have a lawyer, the others have to defend themselves. The situation in the central parts of the country is even worse. Sometimes there are whole provinces where legal services are not available at all.

The independence of the Chinese legislature is also very different from what we are accustomed to in the Euro-American world. Although courts should decide independently, the judicial system's setting is not independent. Police headquarters, which are superior to courts, have the final word. There is also another crucial element in justice matters called political committees, which oversee the work of the courts. Financial dependency on the local government is another rather problematic issue. Although these political bodies do not intervene in individual cases, one cannot expect the court to say that the government is mistaken. It has been suggested by some that to ensure the independence of courts, the system would have to be changed as a whole. The situation is further complicated by the fact that in China all the judicial and bar exams are compatible, so one can work in the field of justice with a bar exam and vice versa.

The local judicial system is also perhaps far too interlinked to the views of the public which can even vote on the Internet on the matter of punishment that should be imposed. Consequently, it has occurred that as a result of the public voting a death penalty was given for a crime that was later – by the same public – considered as not so serious. Eventually, when courts were dealing with even more serious crimes, the public found itself in a delicate situation since they realized the capital punishment had in fact already been given for a less serious offence.

At the end of the lecture a few questions were asked, especially from the students. For instance one of them concerned corruption. Mr. Belkin said that the Chinese government takes the problem of corruption seriously. At times there may be some individuals sentenced for corruption, however there are no detailed provisions for prosecuting corruption. Moreover, information on corruption cases is not publicly known.

Veronika Vilímková