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THE REGULATION OF CREDIT RATING AGENCIES IN
NEW ZEALAND

FROM A PUBLIC LAW PERSPECTIVE: A NECESSITY TO
STEP IN TO REGULATE?

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Abstract

This paper critically analyses a potential regulation of Credit Rating Agencies in New Zealand - in light of the financial crisis - from a public law perspective. The main focus of this research is on the question, whether indeed a comprehensive regulation is indicated, or alternatively, whether the power of the markets is able to cope efficiently and sufficiently with the inherent issues of providing credit ratings; in other words, this paper deals with the clash of regulation v self-regulation.

Word length

The text of this paper (excluding abstract, table of contents, footnotes and bibliography) comprises approximately 14,900 words.

Subjects and Topics

Regulation - self-regulation - New Zealand's regulation on credit rating agencies - public duty and power to step in to regulate - consumer rights - protection of the financial markets - national and global requirements - IOSCO Code of Conduct - comparison of New Zealand, United States, Australian and European regulation of credit rating agencies.

¹ CRA is hereinafter used as an abbreviation for Credit Rating Agency.

² Andrew R. J. by "The European Regulation of Credit Rating Agencies and Retail Markets" (2009)

IMF Working Paper 12/146; Ines J. by "The Global Regulation of Credit Rating Agencies"

(2008) Ludwig-Maximilians-Universität München 14 at 1. <www.epub.uni-muenchen.de/

See, also also, Stefan Hantsch "Yes, we Can (Control Them)! - Regulatory Agencies: Trustees or Agents" (2011) 2 GeIL 1, 111, at 117 and as an example for United States Dodd-Frank Wall

Street Reform and Consumer Protection Act.

³ Reserve Bank of New Zealand "Financial Stability Paper" (November 2009) at 41

www.rbnz.govt.nz/ compare also Stefan Hantsch "Credit Rating Agencies: A regulatory

Challenge for Australia" (AGIS Policy Paper 2009/04) at 40

I Introduction

This paper will examine whether the regulation of Credit Rating Agencies (CRAs)¹ in New Zealand is necessary. Although this topic is, in particular, tightly linked to economic issues, the author will closely look at it from a public law perspective.

At first glance, CRAs seem to be alien for most of the people. Only people who work in the financial sector may exactly know what the role of CRAs is. The remaining part, like the ordinary consumer, has not the slightest idea of CRAs, their tasks and their meaning for national as well as for international financial systems. This situation is far from desirable, as the work of CRAs surrounds and affects consumers almost every day. In fact, CRAs are essential market participants of the national and international financial markets. Governments have not considered their regulation necessary for a long time, even though they have a significant impact on the financial markets, governments, companies, consumers and the modern welfare.² Instead, particularly, (investment) banks and securities firms were facing more and enhanced regulation by governments.³

Regardless of these measures, the latest global financial crisis has occurred. This crisis has given cause to consider the financial markets differently. Both governments at a national level and international organizations all over the world are scrutinising intensively the financial markets and their participants. This scrutiny is taking place to identify the main culprits and problems of the financial crisis as well as to prevent similar crises in the future. A comprehensive reform and review should eventually lead to an understandable and secure investment environment, thus to more financial stability. The intention is to improve market transparency, and in addition, to enhance the present control mechanisms significantly. Therefore goals and measures, which most of the Governments have laid down to cope with the financial crisis, include an enhanced control of market participants and certain investment products.⁴ The regulation of CRAs

¹ CRA is hereinafter used as an abbreviation for Credit Rating Agency.

² Amadou N R Sy "The Systemic Regulation of Credit Rating Agencies and Rated Markets" (2009) IMF Working Paper 129 at 8; Josef Forster "The Optimal Regulation of Credit Rating Agencies" (2008) Ludwig-Maximilians-Universitaet Muenchen 14 at 1 <www.epub.ub.uni-muenchen.de>.

³ See, inter alia, Stefan Handke "Yes, we Can (Control Them)! – Regulatory Agencies: Trustees or Agents?" (2010) 2 GoJIL 1, 111, at 112 and as an example the United States Dodd–Frank Wall Street Reform and Consumer Protection Act.

⁴ Reserve Bank of New Zealand "Financial Stability Report" (November 2009) RBNZ at 41 <www.rbnz.govt.nz>; compare also Tin A Bunjevaca "Credit Rating Agencies: A regulatory challenge for Australia" (AGIS Plus Text, Melbourne, 2009) at 40.

is often among these goals and measures.⁵ Though New Zealand has not yet announced concrete measures.

Apparently, many governments do not consider self-regulation as an adequate option to deal with the problems that have arisen. The traditional notion, that markets can deal with their problems themselves, seems to be thrown entirely overboard. This is, probably, justified by the vigorous impact of the financial crisis on the global economy and the national markets. Thus, it might be a mistake of the New Zealand Government to delay or not undertake at all the regulation of CRAs.

However, this paper will try to find an answer to this question. Part II of this paper gives the background to this, admittedly, alien and complex topic, by explaining the basic terms and the development of CRAs. In the key part, part III, the author will specifically examine the clash of regulation and self-regulation. Starting from the most recent IOSCO Code of Conduct for CRAs and the current New Zealand approach, the paper concentrates on the distinct features of regulation and self-regulation as well as the rights at stake. The consideration of international obligations and requirements will then be subject of part IV. The comparison of New Zealand's approach to the United States, the European Union, the implementation in the United Kingdom, and Australia's current approach will be of a special interest. I will conclude with proposing new regulation of CRAs, being justified by significant risks for the entire New Zealand and global financial system as well as considerable consumer rights at stake.

II Background

A proper understanding of the topic, which is embedded in the financial markets, requires the definition of the basic terms. In addition, I will outline briefly the business of CRAs and their contribution to the Subprime Crisis.⁶

A Basic Terms

Essential for the consideration of the following issues are the terms "regulation", particularly "financial regulation", "markets" and "financial markets", "issuer" and "investor".

⁵ Bunjevaca, above n 4, at 40; Sy, above n 2, at 6,7, 21-29.

⁶ The Subprime Crisis is explained under II B 3.

1 Regulation and financial regulation

The term "regulation" can have very different meanings. Therefore, here, the lines are drawn clearly to identify the relevant meaning.

"Regulation" describes, from an abstract perspective, the act of regulating, or, in other words, an authoritative rule, whereby the exercise of control or governance is laid down.⁷ For purposes of this paper, regulation has to be understood in that sense.

In fact, regulation is omnipresent. Well-known areas of regulation are health and safety regulation, social policy regulation, economic regulation, particularly antitrust, energy, electricity, transport, key industries as the media and environmental regulation.⁸ Most striking is that these areas are highly sensitive in terms of vulnerable consumers, weak market participants and services of general interest. Usually, if Governments ascertain a significant imbalance in, among others, these areas, they react by seeking for appropriate regulation.

Having defined the term "regulation", the in the context of this paper more relevant term "financial regulation" requires intensive consideration. Financial regulation allegedly differs from ordinary regulation. Three distinctive features have been identified.⁹

First, financial regulation often includes the establishment of official regulators with wide powers. Regularly regulators are established to strengthen the outcome of regulation. Normally, these regulators combine legislative, judicial and executive functions. Reasons for their establishment are, inter alia, the wish for a decentralised government, but on the other hand the closeness of governments to the regulated area. Special knowledge of regulators, consisting of experts in the specific area, will lead to the desired closeness. The US Securities and Exchange Commission (SEC) might be the most famous financial regulator. The New Zealand counterpart for investments is, currently, the Securities Commission.

⁷ See and compare Regulations (Disallowance) Act 1989, s 2; see also Julia Black "Law and Regulation: The Case of Finance" in Christine Parker, Colin Scott, Nicola Lacey and others (eds) *in Regulating Law* (Oxford University Press, Oxford, 2004) 33 at 34.

⁸ Philip R Wood *Regulation of International Finance* (Sweet & Maxwell, London, 2007) at [2-010]; see also Marc Schneiberg and Tim Bartley "Organizations, Regulation, and Economic Behavior: Regulatory Dynamic and Forms from the Nineteenth to Twenty-First Century" (2008) *AnnuRevLawSocSci* 31 at 34 and 38 with regard to the "new social regulation".

⁹ Wood, above n 8, at [20-01].

The second distinctive feature of financial regulation is a tendency towards the criminalisation of commercial law, for instance regulatory fines or investigative powers are provided for cases of misconduct. Imminent punishments aim at easing enforcement and increasing the deterrent effect for providers of financial services. Having said this, in contrast to administrative measures, where regularly the notion of compensation dominates, criminal law is intended to function as a deterrent and punishment.¹⁰

Thirdly, a high degree of specific and accurate codification characterises financial regulation. Due to the often complex issues of financial regulation, appropriate codification is a fundamental requirement. As explained above, special regulators are established to deal with the emerging problems. They usually carry out a legislative function. This legislative function can give power to enact binding rules as well as soft law. In light of the special knowledge, which these regulators typically have, the delegation of this power makes sense. Furthermore, this delegation aims at increasing speed, flexibility and accessibility, by simultaneously reducing costs. Rules can be very detailed which, on the one hand, means an advantage for regulated firms. As a result they can easily grasp the content of these rules and comply with them, without struggling with their interpretation. On the other hand though, this detailed approach bears the risks of being too specific and, eventually, of over-regulation.¹¹

Financial regulation has increased recently, mostly targeting at banks, insurance companies and brokers, as the worldwide financial had exposed a significant lack of regulation of these institutions.¹² This increase is taking place in order to restore the stability of financial markets in a sustainable manner.¹³ As financial stability is the main goal of financial regulation, an impressive amount of foreign financial protection systems has been established.¹⁴

¹⁰ Ibid, at [20-04].

¹¹ See and compare *ibid*, at [20-01] – [20-06].

¹² See above n 3.

¹³ Rainer Grote and Thilo Marauhn (eds) *The Regulation of International Financial Markets Perspectives for Reform* (Cambridge University Press, Cambridge, 2006) at 324.

¹⁴ Anup Shah “Global Financial Crisis” (22 August 2010) Global Issues < www.globalissues.org>;
Dick K Nanto “The Global Financial Crisis: Analysis and Policy Implications” (2 October 2009)
Congressional Research Service 7-5700 RL34742 <www.crs.gov>.

2 *Markets and financial markets*

CRAAs act as participants of “markets”, and more specifically, of “financial markets”. Consumers are permanently surrounded by markets in many different guises. Historically, sellers and buyers met at a marketplace. Sellers offered their goods at a certain price, waiting for buyers who bargained for the goods. If they settled on the amount of goods and the appropriate price for the goods, then goods and money were exchanged, and the deal was made. The places, where numerous of these deals were made can be referred to as markets.¹⁵

Today, the grasp of markets differs significantly from this traditional view. Marketplaces in the historical sense are rare, whereas markets are now determined by delocalisation. Deals are made online in the cyberspace, over the phone, by mail or by other means. The modern means of communication have contributed to the new understanding of markets. Simultaneously markets are becoming increasingly less transparent. Sellers and buyers are often not at the same place or even not in the same country or the same continent. Traded products are more complex and more expensive. As a consequence adequate regulation has been required to deal with these issues and imbalances in bargaining power. However, the focus is still on the underlying principle of exchange.

This principle also fits for roughly characterising financial markets. The notion of giving good A to a person C and getting good B from C in return is for financial markets fundamental, even if it is embedded in a complex set of facts and issues and therefore less likely to be easily understood. Financial markets can be formal stock exchanges for equity shares, formal ‘over-the-counter’ markets for many sorts of financial assets, the interbank deposit markets and foreign exchange markets.¹⁶

3 *Issuer of investment products*

The third important term that needs further explanation is “issuer”. An issuer of investment products can be described as a “legal entity (such as a corporation) that is authorized to issue (offer for sale) its own securities”.¹⁷ Securities are, for example, investment products such as stocks and bonds. Banks are well known issuer of these products.

¹⁵ Compare David S Clark (ed) *Encyclopedia of Law & Society American and Global Perspective* (SAGE Publications, London, 2007) vol 2 at 985.

¹⁶ Wood, above n 8, at [20-19].

¹⁷ Definition Issuer <www.businessdictionary.com>; see also Financial Reporting Act 1993, s 4 and the Securities Act 1978, s 2.

4 *Investor*

Of particular relevance for this paper is the “investor”. A sound definition of an investor is:¹⁸

[a]n individual who commits money to investment products with the expectation of financial return. Generally, the primary concern of an investor is to minimize risk while maximizing return, as opposed to a speculator, who is willing to accept a higher level of risk in the hopes of collecting higher-than-average profits.

This definition roughly draws the picture of an individual consumer. Yet, it is obvious that companies like banks, insurance companies and pension funds, and even entire states, belong to the group of investors.¹⁹

B Development of Credit Rating Agencies

The role of CRAs as participants in the financial markets has become significantly stronger during the past few years. To understand the role of CRAs and their increased significance, this paper will outline the business of CRAs first, before shedding some light on the market leaders among CRAs and their contribution to the Subprime Crisis.

1 The Business of Credit Rating Agencies

What is the business of CRAs actually about? Generally, their business is concerned with risk assessment, which serves as a risk indicator for investors and other market participants. One of the CRAs' major task is to provide credit ratings, among others, for banks and insurance companies, whose customers are, to a large extent, consumers. Consumers wish to invest or save their money in a sustainable way, or to obtain proper insurance cover. Credit ratings can help to reach this goal. However, a distinction is made between solicited and unsolicited ratings. In the latter case, CRAs conduct these ratings on their own initiative or due to the mandate of a third party, such as governments or investors. In this case, an issuer of an investment product, for example, is not required to disclose any information. As a result an unsolicited rating bears generally the risk, that CRAs have to rely on publicly available information and the rating is too vague.²⁰

¹⁸ Definition Investor <www.investorwords.com>.

¹⁹ See Interpretations in Investment Advisers (Disclosure) Act 1996, s 2.

²⁰ Uwe Blaurock “Control and Responsibility of Credit Rating Agencies” (2007) 11.3 EJCL 1.

The relevant legislation in New Zealand requires New Zealand's banks and insurance companies to obtain credit ratings from CRAs on a regular basis.²¹ Those credit ratings are, in particular, supposed to provide a simple means for consumers, to understand the banks' and insurance companies' creditworthiness at first sight. Hence, they also fulfill a regulatory purpose.²² One might rightly ask, why that is important. The answer is, that even banks and insurance companies can sail into rough seas, or considering a worst case scenario, go bankrupt, which may, in absence of appropriate safeguards, lead to losses of money, pensions and insurance claims for many consumers. When deciding on a bank or an insurance company, consumers should pay sufficient attention to the present credit rating. An average consumer should be capable to assess the rating, as credit ratings in consumer information usually are in the following format, accompanied by a short explanation:²³

Credit Risk	Moody's	Standard and Poor's	Fitch Ratings
Investment Grade			
Highest Quality	Aaa	AAA	AAA
High Quality	Aa	AA	AA
Upper Medium	A	A	A
Medium	Baa	BBB	BBB
Not Investment Grade			
Lower Medium	Ba	BB	BB
Lower Grade	B	B	B
Poor Grade	Caa	CCC	CCC
Speculative	Ca	CC	CC
No Payments / Bankruptcy	C	D	C
In Default	C	D	D

Grades for creditworthiness are given, reaching from 'Aaa'/'AAA' for the highest level to 'C'/'D' for default/insolvency.²⁴ Even without the understanding of the specific meaning of the credit rating, evidently, a very high rating, such as an AAA, differs from a medium BBB rating. Due to a common lack of financial literacy, however, consumers often do not understand these credit ratings and, in addition, are prone to underestimate the effect of credit ratings in daily life.²⁵ Sellers of investment products are usually also not inclined to point out the meaning of a specific credit rating.

²¹ Reserve Bank of New Zealand Amendment Act 2008, s 17 subs 157 I-K; Insurance Companies (Ratings and Inspections) Act 1994.

²² Compare *ibid.*

²³ Money-Zine.com <www.money-zine.com/Investing/Investing/Bond-Ratings/>.

²⁴ Compare above table, CRAs use distinct grade systems, which are easily comparable though.

²⁵ See III C 1 (b) below; Wood, above n 8, at [20-22] and [20-24].

Another important task of CRAs is to provide credit ratings for specific investment products, such as bonds (forms of loans). As aforementioned, investors thereby receive a single measure to calculate risks as to their own investments.²⁶ Widdowson and Wood characterise this as the estimated likelihood that the issuer of an investment product will be able to meet all its financial obligations on time.²⁷ That means, with regard to the bond, whether the bond is likely to be repaid by the debtor or whether the issuer of an investment product will default or is expected to default.²⁸

An example will make it easier for the reader to understand both the practical issues and, from a legal perspective, the more interesting cry for regulation. The investor, having saved \$10,000 NZD, is contacted by the banker, suggesting a possibility to increase the interest rate on the savings. The banker recommends a particular investment product: a bond issued by a distressed company ("the Company") in Greece, promising a return on investment of 8% for one year. The Company borrows the investor's money for one year in order to improve its own liquidity. It promises the investor that he/she will get the money back at the end of the term, plus interest at the rate of 8%. The investor is delighted as that could facilitate the next trip to the Cook Islands, gaining more than the market standard 1% or 2% interest rate on the savings. Furthermore, the banker tells the investor that the bond is AAA (triple A) rated, which allegedly stands for a very secure investment. Further information in terms of the rating and, in particular, its meaning and potential risks is not provided. The investor has therefore not received any information, other than the current rating, about the bond issuer's creditworthiness. Not being aware of the Company's ability to pay the money plus the interest rate back, a proper risk calculation is almost impossible for the lending investor.

Moreover, credit ratings are also used to determine the creditworthiness of states, governments as well as the above mentioned companies.²⁹

In fact, CRAs have taken on a lot of different responsibilities which affect, particularly, other market participants (such as investors), financial markets and states. Other market participants and many regulators have applied credit ratings to carry out their risk

²⁶ Doug Widdowson and Andy Wood "A user's guide to credit ratings" (2008) 71(3) RBNZ Bulletin 56.

²⁷ Ibid.

²⁸ Wood, above n 8, at [2-015]; also Blaurock, above n 20, *ibid*.

²⁹ See Blaurock, above n 20, at 2; Shahla Motadel "Credit ratings: opinion on credit quality" (1996) 59(2) RBNZ Bulletin 142; for instance NZ banks are required to have a current credit rating.

assessment of, inter alia, investments, by relying largely upon credit ratings. Indeed, CRAs fulfill an important task as providers of information. Therefore, often highlighted benefits of the work of CRAs are: first, they facilitate an independent risk assessment, secondly, they provide information for investors and other market participants in a simple and comprehensive manner, and, thirdly, they contribute to an improvement of institutions' stability by enabling these institutions to strengthen their risk assessment.³⁰

The strong market position of CRAs as well as the inherent deficits of the credit rating process might overshadow these benefits. Along with the provision of information, CRAs have lately gained a strong influence on financial markets. Incorrect or delayed ratings by big CRAs can lead to significant economic consequences, for example, Standard & Poor's Ratings Services downgraded Greece at a point in time, when the bad financial situation there had been well known for a long time.³¹ Nevertheless, the downgrade, in particular, worsened the value of the European currency (Euro) heavily and impaired the European financial markets, such as the stock exchanges.³² These so-called rating crises are not uncommon. "[U]nanticipated and abrupt credit rating downgrades" have occurred before the current crisis.³³ Apparently, like many consumers who have problems to understand credit ratings, even financial experts and entire governments cannot interpret credit ratings correctly. They ignore other available data, like the information with regard to the economic situation in Greece, and rely primarily on credit ratings.

Furthermore, the credit rating process bears some inherent deficits, such as conflicts of interest, a lack of transparency and effectiveness.³⁴ Even before the recent financial crisis, financial experts had raised criticism with regard to these deficits.³⁵ The author will examine them in-depth in part III, as they take centre stage when considering the clash of regulation and self-regulation of CRAs. In addition, this paper tries to point out a solution as to providing a transparent and effective credit rating process. Finding appropriate approaches becomes more and more important. I will underline the significance of

³⁰ Widdowson and Wood, above n 26, at 61.

³¹ Roya Wolverson "The Credit Rating Controversy" (4 June 2010) Council on Foreign Relations <www.cfr.org>.

³² The Financial Regulation Forum "Europe-wide oversight of credit rating agencies" (4 June 2010) <www.financialregulationforum.com>; Andrew Bowen "European Commission plans reform of rating agency regulation" (2 June 2010) Deutsche Welle <www.dw-world.de>.

³³ Sy, above n 2, at 3.

³⁴ Thomas Lee Hazen *Principles of Securities Regulation* (3rd ed, Thomson/West, St. Paul, 2009) at 333-334.

³⁵ See, in particular, IOSCO Code of Conduct (revised May 2008) and Regulation 1060/2009 on credit rating agencies [2009] OJ L 302.

implementing proper regulation by explaining, how CRAs have contributed to the financial crisis.³⁶

2 *The market leaders*

The most important CRAs and simultaneously the market leaders are Standard & Poor's Ratings Services (based in the United States), Moody's Investors Service Limited (based in the United States) and Fitch Ratings (French owned). Two other significant CRAs are A M Best (based in the United States), being specialised in the insurance area, and Canada's Dominion Bond Rating Service. In fact, the market leaders control around 90-95% of the market. These big three, usually referred to as oligopolists, definitely dominate the global credit rating market.³⁷ It is apparent, they play an important role in New Zealand as well. On the other hand, all of the market leaders are non-New Zealand companies, even if they are conducting business in New Zealand. The approved CRAs for (credit) rating banks in New Zealand are, however, the big three.³⁸

In order to underline the worldwide importance of CRAs, the following figures assist. In 2009, Standard & Poor's Ratings Services published more than 870,000 new and revised credits ratings. Currently, they rate more than US\$32 trillion in outstanding debt.³⁹ Moody's says that its ratings and analysis track debt covering more than 100 sovereign nations, 12,000 corporate issuers, 29,000 public finance issuers and 96,000 structured finance obligations.⁴⁰ Fitch Ratings claims that it rates "more financial institutions worldwide than any other rating agency".⁴¹

Frankly, it is not possible to ignore the big picture, the nation- and worldwide impact of the role and work of CRAs in terms of the financial markets and the whole financial system.

³⁶ European Commission "Commission proposes improved EU supervision of Credit Rating Agencies and launches debate on corporate governance in financial institutions" (2 June 2010) Press Release IP/10/656 <www.ec.europa.eu>; Sy, above n 2, at 1 and 3; Bunjevac, above n 4, at 40.

³⁷ Blaurock, above n 20, at 5 and 6; European Commission "Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies" (press release, 12 November 2008) SEC(2008) 2745, SEC(2008) 2746, inter alia at [1.2], [1.3] and [9.6] <www.ec.europa.eu>.

³⁸ Approved by the Reserve Bank, see <www.sec-com.govt.nz/publications/documents/>.

³⁹ Website Standard & Poor's "About Standard & Poor's History" <www.standardandpoors.com>.

⁴⁰ Website Moody's "About Moody's" <www.moodys.com>.

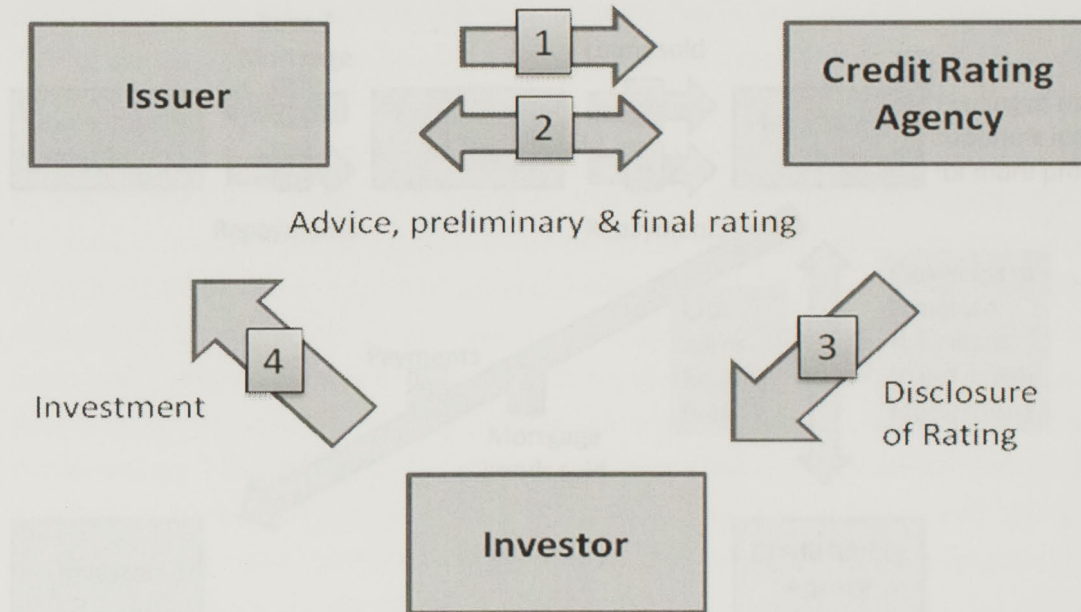
⁴¹ Website Fitch Ratings "About Us Corporate Brochure" <www.fitchratings.com>.

3 *Their contribution to the Subprime Crisis and Financial Crisis*

In fact, CRAs have contributed to the recent financial crisis. Financial experts have identified them as one of the main culprits of the Subprime Crisis, the origins of which lie in the United States and which verifiably initiated the financial crisis.⁴² The author will prove that assumption by outlining the process of achieving credit ratings and elaborating the contribution of CRAs to the Subprime Crisis.

The figure below shows the basic relations between the main market participants in terms of the credit rating process, namely the issuer, the CRA and the investor. It explains simply, how a solicited rating for an investment product is usually accomplished.

Figure 1:



The issuer requests a rating from the CRA (see Figure: 1). Usually, a contract is concluded between both parties, setting the conditions for carrying out the work, which leads to the rating. Accordingly, the issuer provides information and is obliged to pay the CRA; the big three all follow this “issuer pays” business model (see Figure: 1).⁴³ Correspondingly the CRA provides advice and delivers a preliminary, plus a final rating (see Figure: 2). No audit is conducted, though, as people often assume. In contrast to an audit process, a mere consultation takes place during this process. The CRA advises the

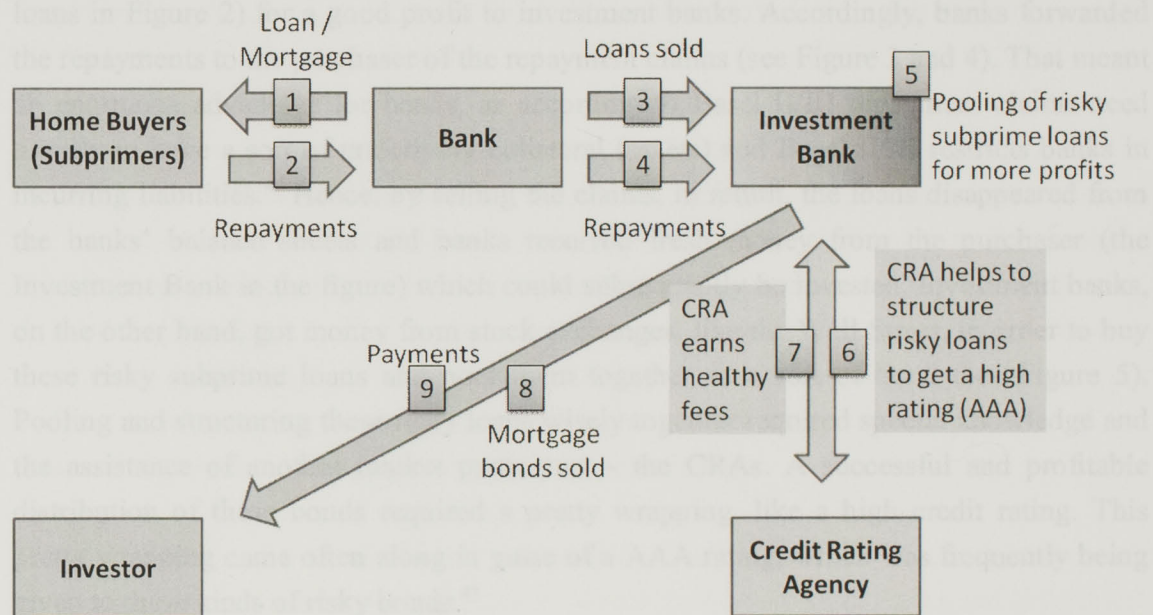
⁴² Bunjevac, above n 4, at 40-43; Blaurock, above n 20, at 26; Sy, above n 2, at 1.

⁴³ See Blaurock, above n 20, at 3, 4 and 7, with further references; Wolverson, above n 31, *ibid*; compare also Sy, above n 2, at 5 with regard to the reliance on information.

issuer how to achieve a good rating, but does not analyse the investment product in such a depth as an auditor.⁴⁴ Then, after finalising the rating process, the rating is disclosed by the CRA (see Figure 3), and often by the issuer, too.⁴⁵ Based on this rating the investor is able to make an investment decision, possibly purchasing the issuer's investment product (see Figure 4). That can happen through a middleman, like the banker in the example, given above.

The Subprime Crisis requires a little more detailed explanation. The following figure illustrates the basic relations between the involved market participants. This occurs, by highlighting the role of CRAs.

Figure 2:



To understand the circumstances which led to the Subprime Crisis, the author briefly describes the usual process of financing a consumer property purchase. Home Buyers in the United States, like in any other country in the world, often needed a loan to finance their property purchase. Banks were keen to grant a loan, if the purchaser met certain criteria. Normally, both parties, the bank and the purchaser, negotiated the terms and conditions of the specific loan agreement and the mortgage. This usually happened by carrying out a check of the purchaser's income. In addition, the bank assessed the

⁴⁴ See Forster, above n 2, at 22 with further references.

⁴⁵ Compare with regard to the rating process *ibid.*

property's value. The assessment took place to determine whether the property was likely to be of value in the event of raising a mortgage claim.

However, prior to the Subprime Crisis, regularly, banks did not conduct the before mentioned income checks and property assessments. Rather banks were inclined to grant these loans/mortgages (see Figure 1, the "Subprime Loans"). Thus, even members of an "underprivileged" class could successfully apply for loans/mortgages. Those people, referred to as "Subprimers" since the Subprime Crisis, were often on the edge of insolvency. According to the specific loan agreements, Home Buyers were required to repay the loans (see Figure 2).

Yet, the question must arise, why banks were so prone to grant loans to people, who carried around with themselves a significant likelihood of defaults on repayments. A teaser for banks was the fact, that they could sell the repayment claims (referred to as loans in Figure 2) for a good profit to investment banks. Accordingly, banks forwarded the repayments to the purchaser of the repayment claims (see Figure 3 and 4). That meant an enormous advantage for banks, as according to Basel II/III repayment claims need usually to have a sort of underlying collateral (assets) and Basel II/III restricts banks in incurring liabilities.⁴⁶ Hence, by selling the claims, in return, the loans disappeared from the banks' balance sheets and banks received fresh money from the purchaser (the Investment Bank in the figure) which could subsequently be invested. Investment banks, on the other hand, got money from stock exchanges, like the Wall Street, in order to buy these risky subprime loans and pool them together as a sort of bond (see Figure 5). Pooling and structuring these risky loans wisely together required special knowledge and the assistance of another market participant - the CRAs. A successful and profitable distribution of these bonds required a pretty wrapping, like a high credit rating. This pretty wrapping came often along in guise of a AAA rating, which was frequently being given to these kinds of risky bonds.⁴⁷

CRAs earned healthy fees as an incentive, in exchange for their advice how to structure these risky loans effectively, in order to receive a high credit rating (see Figure 6 and 7). After wrapping up the risky loans nicely, the newly structured bonds could be sold to investors (see Figure 8). The return on these bonds was a part of the repayments on the

⁴⁶ Marwan Elkhoury "Credit Rating Agencies and their potential impact on developing countries" (January 2008) Discussion Papers United Nations Conference on Trade and Development No 186; Compare Basel Committee on Banking Supervision "International regulatory framework for banks (Basel III)" <www.bis.org> with further references; Basel II was initially published in 2004. It aims at creating international standards for banking and regulators, in particular in relation to an assessment of capital, serving as collateral against cases of risks banks take.

⁴⁷ Sy, above n 2, at 16.

loans (see Figure 9). Being misled by the high rating and a decent return, investors all over the world decided to purchase these bonds. Among them were consumers, banks, insurance companies, pension funds and entire governments.

Initially, in fact all of the before-mentioned involved market participants made a good deal from these arrangements. In particular, banks, investment banks and CRAs made a good and sustainable deal. Predictably though, a rapidly increasing number of Home Buyers was incapable of refinancing the loans. The often weak income situation of the "Subprimers" contributed significantly to that fact. As the property as collateral was not valuable enough to cover the default in repayments, consequently, more and more investors did not receive any return on their bonds. Most of the bonds eventually defaulted. In the end, many investors faced trashy bonds and a total loss of their money, despite having bought a AAA rated bond. Therefore the impact of that risky investment hit "Subprimers" and investors first.

Apparently, though, banks, investment banks and CRAs, had underestimated the potential consequences of their actions. Not surprisingly, the whole financial system was struck by the impact of the so-called Subprime Crisis. Investors lost confidence in the financial markets, hence, abruptly, significantly and globally, investment activity declined. In turn, this led to illiquidity in the financial markets and a tremendously negative effect on economies worldwide and thereby caused the global financial crisis. In addition, for understandable reasons, the housing market in the United States and the entire global real estate market suffered severely from the Subprime Crisis.

In the aftermath of the Subprime Crisis and the recent Financial Crisis, governments increasingly introduced new regulations in relation to the control of banks and investment banks.⁴⁸ In conjunction with this effort, finally, many governments paid attention to the work of CRAs and considered their (comprehensive) regulation necessary.⁴⁹

⁴⁸ See above n 3.

⁴⁹ See regulation in the United States: Credit Rating Agency Reform Act 2006; European Union: Regulation 1060/2009 on credit rating agencies [2009] OJ L 302; Canada: 25-101 Designated Rating Organizations [NI Proposed].

III Regulation v Self-regulation of CRAs

CRAs are, except for some unspecific Guidelines, currently not regulated in New Zealand.⁵⁰ After having defined the most relevant financial terms and illustrated the business and development of CRAs, the time is ripe to examine the key aspect of this paper, namely the clash of regulation and self-regulation. Eventually, after having been focused on the regulation of investment banks and other market participants for a fairly long time, governments around the world have identified CRAs as a market participant, that needs to be regulated.⁵¹ New Zealand has not adopted appropriate regulation, or more specifically, New Zealand follows the global debate on the regulation of CRAs, but:⁵²

the Reserve Bank plans to watch the global debate and then adapt new international standards as they become clearer, where they seem appropriate to the New Zealand financial system.

Accordingly, the Financial Stability Report 2009 published by the Reserve Bank of New Zealand states that “[d]etailed work is under way globally on many issues, including rating agency regulation, accounting standards and executive compensation.”⁵³

The focus of this paper is hence on the following issue in relation to the regulation of CRAs: self-regulation by the markets in contrast to the regulation by the Government, by balancing inter alia market interests and public interests. The most recent International Organizations of Securities Commissions (IOSCO) Code of Conduct Fundamentals for Credit Rating Agencies will help to understand the inherent issues of the credit rating business. Simultaneously, a vivid example of industry self-regulation by a code of conduct is given.

In order to thoroughly elaborate the issue, then the current New Zealand approach in relation to the general use of regulation will be outlined. Thereafter, the author will analyse whether there is indeed room for more regulation and shed light on the source of public power and the public duty to step in to regulate. Goals of regulation and self-regulation will also be identified in this regard.

⁵⁰ See below n 71.

⁵¹ See above, n 5.

⁵² Financial Stability Report 2009, above n 4, at 41.

⁵³ Ibid.

As this paper tries to give a recommendation as to the further regulatory approach of the New Zealand Government to cope with CRAs, the rights at stake need to be balanced carefully. This occurs by going into detail as to the inherent deficits of credit ratings and their meaning for the New Zealand economy. The most crucial issue will be whether an omission of regulation significantly jeopardises consumer rights, rights of investors and rights of other market participants. Alongside this discussion the author will closely look at financial literacy of consumers. In addition, the issue whether there is sufficient competition in the markets is of interest. Striving to provide the big picture, this paper will also give an answer to possibly impaired rights of CRAs.

A The IOSCO Code of Conduct Fundamentals for Credit Rating Agencies

The most interesting piece of self-regulation in relation to CRAs was released even before the recent global financial crisis.⁵⁴ The Technical Committee of the International Organizations of Securities Commissions published first in September 2003 a non-binding Statement of Principles Regarding the Activities of Credit Rating Agencies.⁵⁵ These principles were first not very specific, but, remarkably, as for the first time it was dealt with issues in terms of CRAs.⁵⁶ Major issues were addressed, among other things, independence and conflicts of interest. Take, for example, principle 2.5, that stated: “[t]he determination of a credit rating should be influenced only by factors relevant to the credit assessment.”⁵⁷ In general:⁵⁸

... the Principles laid out high-level objectives that rating agencies, regulators, issuers and other market participants should strive toward in order to improve investor protection and the fairness, efficiency and transparency of securities markets and reduce systemic risk.

As a consequence following publications and international experts concentrated on those principles and pleaded for a more detailed code of conduct. The result is the current IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO Code of Conduct), the latest version is from May 2008.

⁵⁴ Pavlos Maris “The Regulation of credit rating agencies in the US and Europe: historical analysis and thoughts on the road ahead” (27 March 2009) SSRN <www.ssrn.com> at 7.

⁵⁵ IOSCO Statement of Principles regarding the Activities of Credit Rating Agencies (25 September 2003) IOSCOPD151 <www.iosco.org>.

⁵⁶ Ibid.

⁵⁷ IOSCO, above n 55, *ibid.*

⁵⁸ IOSCO Code of Conduct Fundamentals for Credit Rating Agencies at 1.

The IOSCO Code of Conduct serves as a guide and aims at providing a framework for CRAs in different markets and jurisdictions. However, the overarching objective of the IOSCO Code of Conduct is "to promote investor protection by safeguarding the integrity of the rating process".⁵⁹ It is evident that risks as to the credit rating process were identified and the IOSCO Code of Conduct is meant as a voluntary tool to minimize these risks. It particularly deals with three problematic areas, namely the quality and integrity of the rating process, the independence and the avoidance of conflicts and interest and CRAs responsibilities to the public and issuers.⁶⁰ This paper gives examples to each problematic area below.

Measures, which New Zealand could adopt, are in relation to the quality and integrity of the rating process, for example: to conduct a thorough analysis of all information known to the CRA that is relevant for the rating, ratings can be subjected to some form of objective validation; misleading ratings or other information should be avoided and a periodic review system should be established. Monitoring and updating credit ratings is another central issue in the IOSCO Code of Conduct. Moreover, CRAs and its employees should behave with integrity, preventing the entire rating process from being affected by illegal, unfair or dishonest behaviour.⁶¹

Separating its credit rating business from any other business, like providing advisory services to issuers, shall significantly improve CRAs' independence and avoidance of conflicts of interest. In addition, internal procedures to timely identify and manage adequately any conflicts of interest as well as the disclosure of potential conflicts of interest are also high on the agenda.⁶² Conflicts of interest may emerge where an analyst of a CRA has a personal relation with an employee of a rated company or where an analyst has a financial interest in the rated company itself.⁶³

A timely, transparent and comprehensive disclosure of credit ratings is also required. In order to draw a conclusive picture, both the public and issuers necessarily need to comprehend the rating process, the underlying elements and procedures. Information about the last update of a particular rating and whether the issuer has participated in a

⁵⁹ Ibid, at 3.

⁶⁰ Ibid, at 4, 7 and 10.

⁶¹ Ibid, at 4-6.

⁶² Ibid, at 7-8.

⁶³ Ibid, at 8-10.

credit rating process should also be disclosed.⁶⁴ The IOSCO Code of Conduct contains many other provisions, overall it clearly aims at providing the public with a much more transparent and broader picture with regard to both credit ratings and CRAs.

In fact, by 2007, according to a IOSCO Task Force report, the big three CRAs had “substantially implemented” the IOSCO Code of Conduct.⁶⁵ The industry is apparently willing to participate in improving their standards. The author welcomes this development. On the other hand, arguably, the IOSCO Code of Conduct still lacks of one essential feature: enforcement.⁶⁶ There has no authority been established by the industry that supervises and controls CRAs compliance with the new standards. Moreover, the “substantial” implementation of the IOSCO standards means that CRAs certainly aligned the IOSCO Code of Conduct with their own idea of standards. This paper provides below an answer whether that approach copes sufficiently with the emerging problems or not.

Canada obviously considers self-regulation alone not sufficient. The Canadian Securities Administrator (CSA) has recently published for comment the National Instrument 25-101 Designated Rating Organizations and related consequential amendments.⁶⁷ This is an interesting approach, as at first glance the CSA proposal relies largely on the IOSCO Code of Conduct.

Yet, how does that work exactly? CRAs have to apply to become a “designated rating organization” (DRO), that is then allowed to provide its ratings for different purposes under the securities legislation. As soon as the particular CRA becomes a DRO, it is required to establish a code of conduct, which generally complies with the IOSCO Code of Conduct.⁶⁸ It is apparent that the CSA has decided to turn the IOSCO Code of Conduct in this way into a legally binding document. A look at the National Instrument 25-101 makes clear that the focus is on compliance with this code. Additional requirements are laid down in this regulation, concentrating on conflicts of interest. The proposal touches slightly on enforcement, by saying that in cases of conflicts of interest the authority can

⁶⁴ Ibid, at 10-12.

⁶⁵ IOSCO Task Force Report (February 2007).

⁶⁶ Maris, above n 54, *ibid*.

⁶⁷ 25-101 Designated Rating Organizations [NI Proposed] (CDN); BC Securities Commission 2004 “Canadian securities regulators propose regulatory regime for credit rating organizations [CSA]” (16 July 2010) News Release <www.bcsc.bc.ca>.

⁶⁸ *Ibid*.

prohibit the issuing or maintaining of ratings.⁶⁹ This is believed to be a soft approach in dealing with enforcement with CRAs though.

Having this recent and appealing example in mind, the question arises how New Zealand should be dealing with the regulation of CRAs. As the author pointed out that the Government has not yet implemented comprehensive and sufficient regulation, the key question will then be whether Canada's approach may be worth to consider.

B The current New Zealand Approach

As briefly touched on above, unlike the United States, the European Union and Australia, New Zealand has not passed new legislation with regard to the regulation of CRAs.⁷⁰ In fact, the Reserve Bank of New Zealand waits and sees. So far they only set up some rough Guidelines, which deal with the approval of CRAs for the non-bank deposit taker sector.⁷¹ The Guidelines do, in fact, not base on the IOSCO Code of Conduct. The author considers them as shallow and inappropriate. In addition, they cover solely the area of non-bank deposit takers.

This hesitant approach is underpinned by the above quotation, that the Reserve Bank "plans to watch the global debate", before initiating its own regulation.⁷² Logically, then the question comes to mind whether the enactment of appropriate regulation is not indicated and overdue.

Yet, the author can only respond to this issue properly, after having looked at the general approach of the current New Zealand Government in relation to regulation. The Government has issued a statement on regulation, which paints a clear picture of how the current Government approaches regulation.⁷³ The promise is to "introduce new regulation only when we [the Government] are satisfied that it is required, reasonable, and robust". Moreover, existing regulation will be reviewed "in order to identify and remove

⁶⁹ Canadian Securities Administrators "Notice and Request for Comment Proposed National Instrument 25-101 Designated Rating Organizations, Related Policies and Consequential Amendments" <www.bpsc.bc.ca>.

⁷⁰ See Introduction above, part I, p 2.

⁷¹ Reserve Bank of New Zealand "Guidelines for credit rating agency approval for the non-bank deposit taker sector" (2008) RBNZ <www.rbnz.govt.nz>.

⁷² See Introduction above, part I, p 2, see also Reserve Bank of New Zealand "Financial Stability Report" (May 2010) RBNZ at 3 <www.rbnz.govt.nz>.

⁷³ Hon Bill English and Rodney Hide "Government Statement on Regulation: Better Regulation, Less Regulation" (press release, 17 August 2009) <www.treasury.govt.nz>.

requirements that are unnecessary, ineffective or excessively costly".⁷⁴ Considering the rights at stake in this part III and the international approach of regulating CRAs in part IV, this paper will point out that new regulation is absolutely required and reasonable.

1 Changes to the current regulatory system

The potential regulation of CRAs will need to be embedded in, and will presumably be aligned with, the entire regulation of the financial markets in New Zealand. As a comprehensive explanation of the regulation of the financial markets would go beyond the scope of this paper, this paper briefly outlines the situation with regard to the main regulators of New Zealand financial markets. This outline will help the reader primarily to grasp the notion behind the Government's approach, which might also be dominating the discussion as to the regulation of CRAs.

Currently, the Reserve Bank of New Zealand is the main prudential regulator of the financial markets. The Government has announced that, by 2011, a new "super-regulator" will be established: the Financial Markets Authority (FMA). This is particularly in order to win back public confidence in the financial system, which has been heavily diminished since the beginning of the financial crisis. According to Commerce Minister Hon Simon Power: "The Financial Markets Authority (FMA) will consolidate functions currently fragmented across the Securities Commission, the Ministry of Economic Development, including the Government Actuary, and NZX [the New Zealand stock exchange]."⁷⁵ Yet there is going to be a coexistence of the FMA and the Reserve Bank, comparable to the Australian "twin peaks" model, consisting of the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA). The Reserve Bank will keep its powers, unlike the new established FMA, which is expected to be a restructured and strengthened Securities Commission.⁷⁶

2 Purpose of the reform and implications for this paper

Hence, one of the main intentions of this reform is "to win back public confidence" or, in other words, "to restore confidence of mum and dad investors in our [New Zealand's]

⁷⁴ Ibid.

⁷⁵ Simon Power "Government announces 'super-regulator' for financial markets" (press release, 28 April 2010) <www.beehive.govt.nz>.

⁷⁶ Ibid.

financial market.”⁷⁷ The Government has recognized that investors’ money and confidence has been damaged by the lack of a comprehensive regulation. The FMA’s aim would be “visible, proactive and timely enforcement”.⁷⁸ Apparently, the present risks, particularly for investors, are being taken seriously. Yet one might say that if a crisis occurs or other serious deficits are identified, generally governments are quickly inclined to pass new regulation to resolve the present issues. The author, however, is inclined to believe in the intention of the current Government to restore public confidence in a sustainable way and will apply this intention through the remaining parts of the paper. This application occurs though by keeping in mind that the broad use of regulatory measures is commonly not seen as a panacea.⁷⁹

There seems to be an alignment of interests between the Reserve Bank and the Commerce Minister regarding the further development of an efficient regulatory environment. Accordingly, it is necessary to keep a careful eye on the current development. This is particularly so against the background of both the announced establishment of the new “super-regulator”, and an internationally dominated approach as to the regulation of CRAs, which this paper will examine in detail in part IV.

C Striving for a New Zealand Solution: the Clash of Regulation and Laissez-faire

Taking the different goals of regulation and self-regulation adequately into account, the author will be striving to balance the interests of New Zealand and the significant affected market participants, as well as the jeopardised rights, appropriately. This chapter ends with a preliminary result as to the clash of regulation and self-regulation. Eventually, this paper will argue that there are sufficient reasons for regulation. Before doing so the I turn to the identified issues: issues in relation to the work of CRAs that are relevant for justifying New Zealand’s intervention, possibly impaired consumer right, the issue of financial literacy and, finally, the question whether a lack of competition characterises the CRA industry. Then, this author outlines the specific case of financial regulation and its implications.

Goals of regulation in relation to CRAs must be to protect consumer rights, to enhance competition and to secure New Zealand’s financial market, by not suppressing

⁷⁷ James Weir “Super-regulator fast tracked to boost public confidence after collapses” The Dominion Post (29 April 2010) quoting Simon Power.

⁷⁸ Ibid.

⁷⁹ Widdowson and Wood, above n 26, at 62; English and Hide, above n 73, *ibid.*

disproportionately rights of CRAs.⁸⁰ In the author's view, there is definitely both room and need for the regulation of CRAs.

However, there are two possible approaches to resolve the current issue, namely, an intervention by the Government or a laissez-faire approach. The current New Zealand regulatory approach is aiming at, among other things, restoring public confidence in the New Zealand financial markets. This aim, alongside the requirement to step in, which this paper will identify, should persuade the Government to regulate CRAs.

In order to prove the assumption that the Government will be required to step in, this paper deals, from a public law perspective, in-depth with the most interesting question as to the clash of regulation and self-regulation.

The IOSCO Code of Conduct and its implementation by the big three CRAs underlines a self-regulatory approach. This paper will argue though, that CRAs and the other involved parties cannot self-regulate all sorts of emerging problems. New Zealand's consumers need protection by the Government, as important consumer rights are impaired. Moreover, incorrect credit ratings are likely to vigorously affect the domestic financial market. That is exactly the moment when regulation is required, as governments then usually are able to generate solutions, in this case considering and protecting rights of CRAs, issuers, investors and the public. In the event of a decision for new regulation, government regulation must reflect which of those parties require more protection than the other and "whose interests are to count" and in what manner.⁸¹

Deciding about a need for regulation of CRAs demands a proper understanding of their industry and business. Accordingly, the following part provides a clear picture of the main issues. It builds upon the overview of the IOSCO Code of Conduct to identify these issues.

1 Identified issues

This paper identifies three groups of issues which are tied to the question for regulation and are relevant for New Zealand. The first group consists of the specific issues which are related to the work of CRAs. Consumer rights, financial literacy, competition and rights of CRAs belong to the second group. Economic issues, in particular the most recent financial crisis, form the third group.

⁸⁰ Compare Schneiberg and Bartley with regard to common goals of regulation, above n 8, at 33.

⁸¹ Warren J Samuels *The Legal-Economic Nexus* (Routledge, London, 2007) at 12 and 31.

(a) Specific issues related to the work of CRAs

The author turns first to the inherent issues of the credit rating process and the business of CRAs. These are the same as dealt with in the IOSCO Code of Conduct. As shown above, there are three problematic areas: the quality and integrity of the rating process, the independence and the avoidance of conflicts and interest and CRAs responsibilities to the public and issuers.⁸² The potential as well as the need for improving standards, methodologies, internal compliance systems and timely disclosure of information is not deniable. The IOSCO Code of Conduct and its implementation by the big three make this clear.

Further issues have emerged though. In particular the payment methods of the CRA industry has come under fire. The most common payment method is, that issuers pay the CRA (the so called "issuer pays business model"). The example and the description of the Subprime Crisis, given above, both base on that model. The author agrees with several independent studies, that another model, the so called "subscriber pays business model" could be used instead of the "issuer pays business model"⁸³ Under the "subscriber pays business model" investors pay the rater, it therefore prevents conflicts arising out of financial relations between issuers and CRAs. However, this paper argues that in the end appropriate transparency counts the most. Even the common "issuer pays business model" makes sense, if payment streams are transparent.

The special knowledge of CRAs and their unique position in the financial world is considered crucial as well. Governments and regulators worldwide rely on credit ratings, New Zealand alike. The business bases mostly on an adequate information flow and a deep insight into industries as well as financial products. Other companies, industries and even governments do not have the same amount of information available, at least to bundled in the same way. Therefore the process how CRAs come to specific credit ratings is so difficult to comprehend.

(b) Further issues

In addition to the specific issues, there exist other issues, namely consumer rights, financial literacy, competition and rights of CRAs. Some of them might have been the underlying reasons for introducing the IOSCO Code of Conduct, the Canadian

⁸² See above III A.

⁸³ See Wolverson, above n 31, *ibid* with further references.

approach and other already implemented regulation. Due to their significance for a New Zealand solution, this paper stresses these fundamental rights at stake.

(i) Consumer Rights impaired?

Indeed consumer rights are impaired by incorrect credit ratings. Thus, particular attention must be paid to them. In particular, unsophisticated investors are unlikely to comprehend often complex investment products. A credit rating is therefore generally supposed to foster both understanding and risk assessment of consumers, by providing easily understandable ratings. Consumers have, on the one hand, usually not the time, resources or intellectual skills to grasp the structure of a particular tricky investment product. On the other hand, their interest in a decent investment return often dominates investment decisions.

Additionally, the significance of the invested assets for an average consumer must be highlighted. Regularly investments of consumers aim at the financial security of entire families and retirement pensions. Due to a misleading credit rating the financial protection and social security of a family could be heavily impaired. Property rights of consumers are also likely to be at stake.

Wood draws the picture of an, in a financial sense, illiterate and "often stupid" consumer.⁸⁴ Without the intention to follow Wood that far down the path, this paper says that the ordinary consumer as investor belongs to a group of people who, by virtue of a lack of knowledge and the rights at stake, deserves special protection by the Government.

(ii) Financial literacy of consumers

In relation to credit ratings, financial literacy of New Zealanders does matter a lot. Apparently though, financial literacy of consumers has been a long time not seen as a real issue by governments, inter alia, the New Zealand Government.⁸⁵ This might have been a fatal defect, for at least two reasons: financial decisions of non-expert consumers are able to affect both their own wealth and, put in the broader context,

⁸⁴ Wood, above n 8, at [2-022] and [2-024].

⁸⁵ Doud Widdowson and Kim Hailwood "Financial literacy and its role in promoting a sound financial system" 70(2) RBNZ Bulletin 37, at 46; John Y Campbell, Howell E Jackson, Brigitte C Madrian and others "The Regulation of Consumer Financial Products: An introductory Essay with Four Case Studies"(27 July 2010) Social Science Research Network <www.ssrn> at 13 and 38.

even the stability of entire economies.⁸⁶

Interestingly, credit ratings are meant to balance out insufficient financial literacy, in other words a lack of financial knowledge. By simplifying complex financial facts and casting them in the mould of specific credit ratings, at least theoretically, CRAs provide consumers with a tool to easily grasp the risk of particular investments.⁸⁷ This requires though, that credit ratings are correct and not misleading. As a consequence this paper recommends the New Zealand Government to considering the issue of financial literacy thoroughly when deciding about the regulation of CRAs.

Financial literacy can be broadly defined as “the ability to make informed judgements and decisions regarding the use and management of money”.⁸⁸ Effectively, consumers with a higher level of financial literacy are able to think through their investments or monetary decisions thoroughly as well as conducting reasonable risk assessments. The level of financial literacy influences in turn decisions of banks and other providers of financial products. The better consumers understand these products and, accordingly, invest their money and take credits carefully, the more banks have to offer appropriate products to meet their clients’ needs. This, arguably, can mean a huge difference for New Zealand’s economy. That difference becomes clearer when considering the fact that the household sector holds financial assets and liabilities of an enormous size.⁸⁹ Whether that money is kept under the pillow, invested in real estate property or given to companies as part of a bond investment, directly influences the domestic economy.⁹⁰ The more consumers handle their financial affairs in the same way, the stronger is the effect on the economy.

However, research has found out that “many New Zealanders have limited financial literacy”.⁹¹ The Government’s aim should therefore be to increasing financial literacy among New Zealand consumers. Credit ratings are likely to contribute to reach that aim, if they are correct and reliable. On the other hand, a situation, where consumers

⁸⁶ Ibid, Widdowson and Hailwood, at 37; Campbell, Jackson, Madrian and others, at 3.

⁸⁷ Compare paragraph above, III C 1(b) (i).

⁸⁸ Widdowson and Hailwood, above n 85, at 37, with reference to Somnath Basu “Financial literacy and the life cycle” (2005) Washington, DC: Financial Planning Association.

⁸⁹ Ibid, at 38-39; Campbell, Jackson, Madrian and others, above n 86, at 5.

⁹⁰ See example, given above under II B 3.

⁹¹ Widdowson and Hailwood, above n 85, at 42-44, with reference to the surveys conducted by the ANZ in 2006 and the Reserve Bank in 2007.

rely blindly on credit ratings is also far from desirable. This view is underpinned by the statement that credit ratings are not determined as recommendation to buy or sell investment products.⁹² Despite that common statement, or rather disclaimer, and somehow comprehensibly, as a matter of fact, consumers orientate themselves by the means of credit ratings.⁹³

In the meantime the issue of financial literacy has been identified by governments worldwide.⁹⁴ Work is under way to strengthen financial literacy, among other things, by improving disclosure standards and changing regulation of financial advisors.⁹⁵ Given that, does limited financial literacy really vindicate a regulation of CRAs? This paper argues so, even if it is not financial literacy itself which lastly justifies regulatory measures, it reasonably completes the reasons yet given, not to forget its considerable influence on the economy and the potential outcome for consumers. Clearly understandable and reliable financial information like a credit rating will enable even unsophisticated consumers to come to a sound financial decision, when facing an “ever-increasing diversity of financial products and services”.⁹⁶

Though the recent past has shown that the tool credit rating has occasionally been either incorrect/not up-to-date or was deliberately used as teaser for particular products by financial advisors without providing comprehensive information. In order to protect consumers to the utmost extent, regulation suggests itself. Poor financial choices are likely to decrease financial wealth and increase debt levels.⁹⁷ To underline that argument with a figure: “Over the decade to December 2006, household debt [in New Zealand] has increased almost three times”.⁹⁸

Undoubtedly, financial illiteracy is an issue in New Zealand, and coupled with inappropriate credit ratings inevitably (financially) worsening New Zealand consumers

⁹² Motadel, above n 29, *ibid*: compare Widdowson and Wood, above n 26, at 58.

⁹³ “Some Credit Sails clients given access to buyback” By TIM HUNTER - BusinessDay.co.nz Last updated 05:00 15/07/2010 (THE DOMINION POST): “Investors now facing losses of close to 100 per cent were told Credit Sails notes were capital-protected and carried a AA rating from Standard & Poor's.”

⁹⁴ Widdowson and Hailwood, above n 85, at 41-42, 44-46; Campbell, Jackson, Madrian and others, above n 85, at 11-19.

⁹⁵ Widdowson and Hailwood, *ibid*, at 46; Campbell, Jackson, Madrian and others, *ibid*, at 15-19.

⁹⁶ Widdowson and Hailwood, *ibid*, at 38.

⁹⁷ *Ibid*.

⁹⁸ *Ibid*.

and households. The 2006 ANZ-Retirement Commission Financial Knowledge Survey and a 2007 poll commissioned by the Reserve Bank of New Zealand indicated,⁹⁹ that New Zealanders “do not effectively understand the basic financial terms or instruments or, more worryingly, the concept of risk and return”.¹⁰⁰

There can be no doubt, that more financial education is needed to sustainably enhance financial literacy.¹⁰¹ Regulation on the other hand cannot lead to more sophisticated financial decisions, but it can improve the protection of non-expert consumers.

According to the cited surveys consumers are well-aware of credit ratings.¹⁰² Apparently, credit ratings are accepted by consumers and play an important role in financial decision making. Consequently, the cry for a regulation of CRAs must become even louder. Information asymmetries between financial experts and non-expert consumers need to be reduced, financial decisions have to be based on simple and reliable information.¹⁰³ A clear lack of consumer financial knowledge in conjunction with the potential negative outcome for consumers and the economy are good reasons for a regulatory intervention.

(iii) Competition and other rights at stake

The importance of a regulation of CRAs is underpinned by looking at the further issues at stake: competition and the quasi-regulatory function of CRAs.

Due to the dominant market position of the big three CRAs, it is commonly referred to them as oligopoly, a condition where “[a] market [is] dominated by a small number of participants who are able to collectively exert control over supply and market prices”.¹⁰⁴ Smaller CRAs are present, but rare and not significant for the credit rating market.

In fact, there is a significant lack of competition. Yet competition is a basic requirement for self-regulation, facilitating self-correcting of market failures and contributing to a fair market environment.¹⁰⁵ The ongoing global discussion is reflecting this issue. The European approach, as the author will show in part IV,

⁹⁹ Hereinafter referred to as “surveys”.

¹⁰⁰ Widdowson and Hailwood, above n 85, at 44-45.

¹⁰¹ *Ibid.*, at 44.

¹⁰² *Ibid.*, at 43.

¹⁰³ Campbell, Jackson, Madrian and others, above n 85, at 5.

¹⁰⁴ Definition Oligopoly <www.investorwords.com>.

¹⁰⁵ *Ibid.*; Blaurock, above n 20, at 6, 29 and 30.

suggests to establish a European CRA which could compete with the big three.¹⁰⁶ It is questionable whether this would finally lead to more competition. This paper argues that improving the requirements for smaller CRAs to enter into the markets and to compete with the big CRAs is a more promising measure.

The quasi-regulatory function of CRAs regarding banks and other financial and insurance companies supports the cry for regulation. These companies are obliged by law to obtain a rating from an approved rating agency.¹⁰⁷ As a result, companies, governments and investors rely on these ratings.

As a consequence of carrying out this important supervisory function in light of the whole financial system, CRAs must comply with enhanced regulatory standards.

(iv) Rights of CRAs impaired?

When looking at possibly infringed rights of consumers and the other yet discussed issues, one is inclined to forget possibly impaired rights of CRAs. Undoubtedly, there are also rights at stake. CRAs collect data, gather different sorts of information and are in an ongoing exchange with market participants, for example issuers of investment products, in order to form an opinion about a specific investment product. This opinion is then transformed into a credit rating and usually published. As a consequence potential regulation, which would restrict CRAs in their doing, is possibly able to infringe at least the freedom of opinion, information or press, as governed by section 14 of the New Zealand Bill of Rights Act 1990.¹⁰⁸

Generally speaking, everyone could be collecting information about an investment product, conducting a rating process and publishing own credit ratings. That explains why credit ratings regularly fall outside existing, non-CRAs specific, financial regulation. It is apparent that CRAs would, based on this potential infringement, use this point definitely as an argument for self-regulation. This, certainly, at first glance seems to be a reasonable argument. At second glance, this argument loses weight, when looking closely at regulatory measures, already undertaken in other markets like the United States and the European Union, that New Zealand might decide to follow.

¹⁰⁶ See below under IV C 1, and Edmund Parker and Miles Bake "Regulation of credit rating agencies in Europe" (2009) 7 JIBFL 401, at 402.

¹⁰⁷ See Reserve Bank of New Zealand Amendment Act 2008, ss 157I-K and Insurance Companies (Ratings and Inspections) Act 1994, s 5.

¹⁰⁸ Compare Blaurock, above n 20, at 23.

Regulation in the United States and the European Union applies solely to ratings, which are used for regulatory purposes. Accordingly, if CRAs want to provide ratings for these purposes, they have to apply first for registration and meet the required standards.¹⁰⁹ As a result CRAs do not longer publish a mere opinion, they deliver a credit rating for a particular purpose, required by governments. This is a simple trick to get around the high hurdle of the freedom of opinion, by simultaneously taking this fundamental right adequately into account. If New Zealand follows the regulatory approach of the United States and the European Union, the freedom of opinion will not be infringed.

The positive outcome for the financial sector is, that essential assessments for systemic important banks have now to be provided by registered CRAs, complying with enhanced standards.¹¹⁰ The big three CRAs are likely to comply with these requirements, in particular to be able to deliver their services in the specific market. However, this approach evidently creates a huge gap. Other than the big CRAs might decide to focus on credit ratings which are not used for regulatory purposes.¹¹¹

Another concern is, given other regulatory regimes and the fact, that current regulation "goes beyond the IOSCO Code of Conduct", smaller CRAs in third-countries may have issues to act in accordance with these rules.¹¹² As a result this approach is likely to be decreasing competition in the markets in the United States and the European Union. The market for smaller CRAs might diminish significantly in size. In order to avoid similar consequences in New Zealand, rights of smaller CRAs must be appropriately considered.

The big three CRAs have "substantially" implemented the IOSCO Code of Conduct, which requires comprehensive transparency, restrictions in conducting business and broad disclosure of information. At least theoretically, CRAs could raise the criticism that governments who impose similar responsibilities on them, disproportionately infringe their businesses. On the other hand, provisions such as: "the credit analyst must be competent", or "the credit analyst must not be in a close relationship with an employee of the issuer", are in accordance with best practice.

¹⁰⁹ As laid down in the EC Regulation and US Regulation, above n 49.

¹¹⁰ Ibid.

¹¹¹ Compare Parker and Bake, above n 106, *ibid.*

¹¹² Ibid.

Another argument for self-regulation, which can be raised by CRAs, is liability. Possibly, CRAs face liability for incorrect ratings. Why is then comprehensive regulation required? The Subprime Crisis illustrated what the impact of a large number of incorrect credit ratings can be. This paper hence argues that private liability is not sufficient to deal adequately with the current issues. Moreover, if credit ratings are opinions, that anyone could issue, it is unlikely that investors could successfully sue CRAs.¹¹³

(c) Economic issues and the most recent financial crisis

Economic issues are the third group of identified issues. Again, the author highlights three areas: the role of CRAs in the current financial world, the most recent financial crisis and public confidence in CRAs and financial markets generally.

Due to the regulatory function, governments commissioned CRAs with, the role of CRAs in the current financial world is often referred to as gatekeeper function. CRAs rate banks and insurance companies all over the world, assessing their risks and whether they meet the Basel III or Solvency I, which as an equivalent to Basel III applies to insurance companies in the European Union, capital requirements.¹¹⁴ As a consequence, these credit ratings affect globally governments, companies, consumers and many others, that use for example banking services. This service has become so important in our modern world.

Therefore this unique position of CRAs often leads to criticism, which this paper shares.¹¹⁵ As a result of being highly familiar with their customers, in particular with their products, and gathering the relevant sorts of information, CRAs possess valuable special knowledge, which is pooled together by the CRAs and exclusively used for their purposes.

Both the recent past and the global big picture show that the consequences of incorrect credit ratings and an unregulated CRA industry, in particular the most recent financial crisis, must give cause to reconsider the current (self-)regulation of CRAs. Further crises are likely to occur. As other governments have passed regulation in relation to CRAs, New Zealand is well advised to take into consideration whether and how to join them. Calls for enhanced regulation of CRAs have, and justifiably so, not fallen

¹¹³ Ibid.

¹¹⁴ Basel III / Solvency I.

¹¹⁵ Bowen, above n 31, *ibid*; The Financial Regulation Forum, above n 32, *ibid*; compare also the IOSCO Code of Conduct, above n 58, at 1.

silent since 2008.¹¹⁶ Bunjevac stated, referring to Australia, that “the measures proposed by the US and EU are both justified and necessary, and recommends the adoption of a number of these proposals and legal concepts into Australian law”.¹¹⁷ Accordingly, in the meantime Australia has introduced new regulation.¹¹⁸

The importance of this approach becomes crystal clear, by recalling the above drawn picture of the emergence of the Subprime Crisis in the United States.¹¹⁹ Initially, the above called bonds, or, more specifically, structured investment products (Asset Backed Securities (ABS), Residential Mortgage Backed Securities (RMBS) and Collateralized Debt Obligations (CDO))¹²⁰ themselves were quickly blamed as the culprits of the Subprime Crisis and the following financial crisis. As a consequence investors, governments and regulatory bodies blamed primarily the issuers of these products for the crisis. First, the contribution of CRAs to the crisis was completely ignored. Yet the contribution of CRAs, namely incorrect ratings, paired with a lack of investor trust inevitably has caused a considerable lack of liquidity in the markets. Among others, the loss of this money led to financial instability and eventually left consumers and likewise (private) companies or governments sailing close to the wind, or in other words, on the brink of insolvency. As further crises of a similar extent need to be prevented, governments must focus on a regulation of CRAs.

User of credit ratings, consumer and companies, have lost confidence in CRAs and financial markets generally since the recent financial crisis.¹²¹ Simultaneously, reputation, which was once considered the biggest asset of CRAs seems to be gone. Considering the losses, many investors have suffered, that is quite understandable. The look of investors and the public at financial markets has also changed. The author believes that they have become more aware of the real nature of financial markets. I look upon this fact favourably, as financial markets “tend to be especially prone to frequent crisis and flux” and “are notoriously vulnerable to self-fulfilling speculative ‘bubbles’ and attacks”.¹²² This is something the public must be aware of. However the author considers the most recent random market reactions, market losses, illiquidity

¹¹⁶ Hazen, above n 34, *ibid*.

¹¹⁷ Bunjevac, above n 4, at 42.

¹¹⁸ See below under IV D.

¹¹⁹ Sy, above n 2, at 15-17.

¹²⁰ Asset-Backed Securities, Residential Mortgage-Backed Securities, Collateralized debt obligations.

¹²¹ Bunjevac, above n 4, at 44; Campbell, Jackson, Madrian and others, above n 86, at 3.

¹²² Grote and Marauhn, above n 13, at 43.

and insolvencies, especially of systemic important banks as a result of a lack of regulation, inter alia of CRAs, and market instability.¹²³

2 *The general case of regulation*

I have already pointed out that New Zealand might be required to step in to regulate CRAs. The market standard credit rating process has evidently led to many problems in financial markets and features many issues itself. In the author's view, agreeing with many financial experts, CRAs have contributed significantly to the financial crisis.¹²⁴ A brief summary will help to understand the following analysis of regulation.

Is CRA's contribution to the Subprime Crisis sufficient, however, to require government action? Even though the latest financial crisis has hit New Zealand and CRAs are conducting business here, and are thus likely to influence the New Zealand financial system, investors and consumer rights, the public perception might be that there are more urgent tasks for the Government to cope with first. Understandably, the public perceives the Government's duty to step in to regulate mainly in areas where essential and basis public services are at stake.¹²⁵

Given this picture of regulation, this paper will, firstly, further examine briefly the goals of regulation and self-regulation, in particular, in relation to CRAs, before setting the issues and rights at stake, identified above, in relation to each other and answering whether the regulation of CRAs is, in fact, required.

The abovementioned common subjects of regulation give a hint what reasons for new regulation often are, inter alia the following:¹²⁶ providing welfare and social security, enhancing competition, adequate protection against internal and external threats, efficiency, legitimacy criteria, accountability and transparency. These reasons reflect fundamental rights and principles like property and competition, which were identified above as being negatively affected by the current work of CRAs and the existing oligopoly.

Yet, it is evident that disadvantages are also tied to regulation, like over-reliance on

¹²³ Sy, above n 2, *ibid.*

¹²⁴ See above under II B 3.

¹²⁵ See for typical subjects of regulation above II A 1.

¹²⁶ Compare Schneiberg and Bartley, above n 8, at 33.

regulation, costs, ineffectiveness and red tape. In addition, governments are prone to over-regulate, especially nowadays risk aversion is the impulse of regulation.¹²⁷ Accordingly, governments face a crucial task when being confronted with a cry for more or enhanced regulation. This requires an exact consideration of both the advantages and disadvantages of regulation, precisely compared with the means of self-regulation.

The New Zealand Government emphasises the importance of an outstanding regulation.¹²⁸ Ultimately, the Government aims at establishing an improved place for conducting business while simultaneously going global and offering an internationally competitive spot.¹²⁹ This is intended to enhance New Zealand's position in the world and compensate for the country's small size and specific geographical isolation.¹³⁰ Yet, by what means can this be reached? Apparently, both better and less regulation is preferable, as "outdated, poorly conceived and poorly implemented regulation can significantly hinder individual freedom, innovation and productivity".¹³¹ The current Government perceives the danger of over-regulation as an issue. It is said in the Government Statement on Regulation that, therefore, balancing thoroughly the pros and cons of regulation in a specific area on a case-by-case basis seems desirable.

The New Zealand Government appears aware of the fact that regulation is a double-edged sword, featuring both pros and cons. After having identified the main pros for regulation, the following section will deal with the specific case of financial regulation and provide the main reasons for self-regulation, which, roughly speaking, in the case of dealing with CRAs can be turned into the cons of regulation.

3 *The specific case of financial regulation - reasons for laissez-faire?*

As the focus of this paper is on financial regulation, it makes sense to outline the aims of financial regulation. It aims generally at stability of the financial system. Governments therefore should regulate with the objectives of reducing costs and, in particular, risks, providing stability and predictability and taking property rights appropriately into account.¹³²

¹²⁷ Wood, above n 8, at [21-05]–[21-06].

¹²⁸ See English and Hide, above n 73, *ibid.*

¹²⁹ *Ibid.*

¹³⁰ *Ibid.*

¹³¹ English and Hide, above n 73, *ibid.*

¹³² Wood, above n 8, at [1-023].

The underlying notion of (financial) regulation sees free markets limited in their capability to cope with the emerging problems. Self-regulation is often able to cope more appropriately and successfully with problems than regulation. Industries can govern their own affairs and businesses, laying down own rules and standards, thus increasing growth.¹³³ Companies of a particular market are familiar and closely connected with the industry. Therefore advocates of self-regulation claim this special institutional knowledge, alongside a high self-interest to manage issues properly, flexibility, and cost-effectiveness as key benefits for the specific market as well as for the entire economy.¹³⁴ Well-functioning self-regulation requires sound competition and an almost ideal market environment though. Wherever there is a significant lack of competition, like in a monopoly and, possibly, also in an oligopoly like the existing one in relation to CRAs, these requirements are not met. Moreover, what happens in cases of market failures? Markets might be able to correct some market failures, but certainly not all. If government intervention becomes eventually necessary, then to what extent requires this regulation?

Considering the needs of and providing protection for quite distinct market participants at different stages is a challenging task, for the industry as well as for governments. Failures in this consideration process might result in reducing consumer rights, diminishing competition or a lack of public confidence in financial products, in other words, a higher risk to financial systems.¹³⁵ Financial regulation aims specifically at avoiding these risks, which can develop into systemic risks. Systemic risks can be domino effects, in particular, if there occurs a bank bankruptcy, which causes further bankruptcies and eventually heavily affects an entire financial system. In such an event, it is very likely that investors (among others consumers) will have to write off their invested money in total.¹³⁶

Further important objectives of financial regulation are the protection of the public and unsophisticated investors, education of the public and information transparency.

¹³³ Compare Business NZ "Regulation Perspectives" (13 Jul 2006) < www.businessnz.org.nz > at 2-6.

¹³⁴ Ibid, at 10.

¹³⁵ Wood, above n 8, at [2-022]; with further references Grote and Maruhn, above n 13, at 260; compare John Williamson and Molly Mahar *A Survey of Financial Liberalization, Essays in International Finance* (Princeton University, Princeton, 1998) at 211.

¹³⁶ Compare Wood, above n 8, at [20-22].

Moreover, it must be complied with principles as to providing a level playing field and market confidence, prevention of crime, having efficient enforcement methods and maintaining competition.¹³⁷

4 *Implications: sufficient reasons for regulation?*

The issues of the credit rating process were identified and addressed in the example and the description of the Subprime Crisis as well as by the IOSCO Code of Conduct, namely conflicts of interest, special knowledge of CRAs and their unique position, and a lack of transparency.¹³⁸ Given these issues, the rights at stake and the notions of (financial) regulation and self-regulation, this paper argues for a regulatory intervention by the New Zealand Government. There are sufficient reasons for regulation.

The perception of New Zealand is that it is a remote country and from an economic perspective not a big player, compared to other countries in the world. Nevertheless, CRAs, as one of the main culprits of the most recent financial crisis, conduct business here and the financial markets as well as consumers have been hit by the financial crisis either.

However, while bearing the reasons for regulation and self-regulation in mind, the Government must first precisely consider whether they are able to resolve the present issue without taking regulatory measures. This accords with the Government Statement on Regulation, the Government "does not see regulation as the first resort for problem solving".¹³⁹ The current Government sees an obligation to fulfil its responsibilities only where new regulation is "required, reasonable, and robust".¹⁴⁰ As a consequence the hurdle to enact new legislation appears considerably high. It is certainly comprehensible, that governments cannot and must not enact regulation which aims at covering comprehensively the conduct of entire societies and businesses, just in order to secure any rights which might be impaired. The inherent defect of such governmental aim seems to be obvious. It increasingly leads to a dangerous condition of over-prescription, over-protectionism, unrealistic expectations of the public and impracticality.¹⁴¹ Permanent reliance on government protection in all regards of daily life is rather in contrast to the

¹³⁷ Ibid.

¹³⁸ Blaurock, above n 20, at 7; Sy, above n 2, at 1.

¹³⁹ See English and Hide, above n 73, *ibid.*

¹⁴⁰ Ibid.

¹⁴¹ Wood, above n 8, at [20-23].

purpose of regulation than meeting the intended objective of securing the public against dangers like poverty, hunger or homelessness, and providing the access to basic resources like power/electricity and telecommunication.

Possibly, therefore a laissez-faire approach copes more appropriately with the present issue. The CRA industry countered upcoming criticism in 2003/2004 by approving the IOSCO Code of Conduct.

Advocates of this liberal opinion would, starting from the IOSCO Code of Conduct as well as ideas of individual responsibility and efficient markets, consider regulation of CRAs generally not required. According to the liberal opinion, both the financial markets and other CRAs would discipline CRAs in the event of incorrect ratings, a lack of disclosure with regard to the rating process or other essential information, and other sorts of professional misconduct. This liberal approach is supported by the fact, that, evidently, the regulation of CRAs is on the edge of the public-private-law divide. In general, private companies conduct business. In cases of losses or misconduct, private liability might solve the emerging problems. One could therefore ask for obligations of CRAs to pay investors money back, for investor compensation schemes, for explicit rights to sue CRAs, for liability and what other kind of protection makes sense. Yet, this paper has shown, that private liability is unlikely to resolve the present issues. Instead it leads to insufficient consumer protection.

According to the liberal opinion, ultimately, only a hazard of serious and continuing rating failures, leading to losses of consumers and financial markets, could justify appropriate regulation.¹⁴² This hazard exists, as the author has identified. Therefore, even advocates of a liberal approach need to accept the tremendous relevance of the regulation of CRAs. The IOSCO Code of Conduct was a beginning, but by far not the cure for the inherent diseases of CRAs. The most recent crisis underlined that view. Code of conducts and self-regulation by the markets did not prevent this crisis. In addition, in the author's view mandatory transparency standards, disclosure requirements, internal procedures for minimizing risks and conflicts of interests were not implemented.

Therefore the author does not agree with advocates of the liberal self-regulatory approach. The financial crisis has clearly illustrated that CRAs are capable to jeopardize consumer rights like property, social security of entire families and to cause enormous harm to national and global financial systems.¹⁴³ Moreover, the Government has to have issues like a sustainable and sound economy, fostering investment opportunities,

¹⁴² See and compare *ibid.*

¹⁴³ See the example, given above, and Figure 2 with regard to the Subprime Crisis, both under II B 3.

providing an appealing market environment and protecting market competition high on the agenda.¹⁴⁴ Future systemic risks have also to be avoided.

As the author considers financial literacy of consumers particularly crucial, this paper takes up this issue again. There is a clear lack of financial literacy among New Zealanders. In particular consumers often have no other means at hand than credit ratings to carry out a proper risk assessment.¹⁴⁵ They are often not aware of the limited information value and that "the business of credit analysis is inherently subjective and therefore imprecise".¹⁴⁶ People are hence prone to believe in financial advisors, like the banker in the example, and to rely on credit rating, without questioning the information received. Interestingly, exactly that notion of over-reliance is usually raised as criticism against regulation. I am not going to allege that CRAs have dishonest motives, but by providing credit ratings in the common simple form they virtually take advantage of both over-reliance and illiterate consumers. Enhanced disclosure standards and information how a certain credit rating was reached are therefore necessarily required.

This paper raises the clear lack of competition in the CRA industry as a further argument for regulation. If smaller CRAs succeed in having a foot in the door of the big market, a free market comes closer, probably also vindicating a reduction of regulation.

Another important issue is the current payment method in the CRA industry. Due to the "issuer pays business model", financial interests on both sides are blended. A significant number of CRAs hence depends on issuers and their healthy fees. Somehow understandably, issuers are not really keen to pay for a service, which then results in a BBB rating of their investment product. That might have been the reason why CRAs have, for a long time, offered advisory services for issuers how to achieve higher ratings. The "subscriber pays business model" is an option to avoid most of the issues, the author would prefer an appropriate level of transparency though.

However, the ideal picture of CRAs looks different: CRAs are supposed to be independent referees, providing independent and objective results.¹⁴⁷ Yet, CRAs have

¹⁴⁴ See and compare *ibid.*

¹⁴⁵ Widdowson and Hailwood, above n 85, at 43-44.

¹⁴⁶ *Ibid.*

¹⁴⁷ *Ibid.*; see also Sy, above n 2, at 6.

abandoned this role, and instead have moved to the risk centre of financial markets.¹⁴⁸ Not deniable striking conflicts of interest are tied to the work of CRAs. Indeed, CRAs have a strong economic interest in establishing tight and sustainable business relationships with issuers of investment products and other relevant market participants. That seems only fair and reasonable, as these relationships are the core of the business of CRAs.

As a result this paper follows the traditional regulatory capitalist, who is inclined to see increased risks and a misuse by unregulated CRAs. However, as the following examples of international regulation on CRAs will show, a black and white approach is certainly not helpful to resolve the present issues. Instead of interfering too vigorously into the business of CRAs, the basic risks of this business should be mitigated.¹⁴⁹ Undoubtedly, determining rights and responsibilities in the light of their economic significance is one of the most important tasks of governments.¹⁵⁰ Ideally, before the New Zealand Government passes new regulation, an eager consultation of, investors, consumers and CRAs should be taking place. Eventually, regulation has to take the rights of CRAs appropriately into account.

D Conclusion

The author argues that an appropriate regulatory intervention by the New Zealand Government will be the best way to accommodate the public interest and the individual autonomy and responsibility of CRAs. In particular consumer and investor rights, competition and the financial stability are at stake.

However, the issue of financial literacy illustrates that regulation of CRAs must be supported by further measures to prevent further crises and a misuse of financial products. Even though being a helpful tool for investors, the perception of credit ratings must change. Investors must learn not to blindly over-rely on one source of information.¹⁵¹ Financial advisors must be forced to explain the limited meaning of credit ratings in an understandable way to consumers. Then credit ratings can be what they

¹⁴⁸ See Elkhoury, above n 46, at 11; Sy, above n 2, at 1 and 4; see also the explanation to the Subprime Crisis above under II B 3.

¹⁴⁹ Wood, above n 8, at [20-24].

¹⁵⁰ Compare Samuels, above n 81, at 24.

¹⁵¹ Regulation 1060/2009 on credit rating agencies [2009] OJ L 302/1.

originally were meant to be: simple tools, assisting to decide whether to make an investment or not.¹⁵²

IV Consideration of International Obligations and Requirements

New Zealand's focus needs to be first on national interests and requirements, even with regard to the overseas based CRAs and international investment products. Yet, of big importance is the question whether alongside national requirements, cross-border transactions and the globally undertaken measures to cope with the issues related to CRAs indeed affect New Zealand's approach.¹⁵³ This paper argues that New Zealand should embrace an internationally labeled approach, before turning to the recent regulation in the United States, the European Union and Australia

A Being part of the global community

Resulting from the globalisation of the financial markets the current situation in New Zealand has to be set in relation to the yet passed regulation in other countries. Nowadays, especially within the current global crisis, a country cannot set itself apart from the rest of the world. This has been made crystal clear by Hon English and Hide in the Government Statement on Regulation.¹⁵⁴ Being part of the global community and being able to affect other countries and financial systems by regulating the domestic investment environment as well as being likely to be affected by them imposes international obligations and requirements on New Zealand.

Theoretically, New Zealand has the choice to be different and to rely on self-regulation and regulatory measures taken elsewhere in the world. Given its responsibility against its citizens and economy, the closeness to Australia and the United Kingdom, this paper sees this as a further argument for regulation. Even CRAs demand global consistency,¹⁵⁵ presumably, primarily in order to reduce their own compliance costs, resulting from different regulatory regimes, and to enhance legal certainty for themselves. However,

¹⁵² See III C 1 (b) (ii) above in relation to financial literacy.

¹⁵³ Compare Hal s Scott *International Finance: Law and Regulation* (2nd ed, Sweet&Maxwell Ltd, London, 2008) at [1-007].

¹⁵⁴ See English and Hide, above n 73, *ibid*.

¹⁵⁵ DBRS Structured Finance Newsletter (4 May 2009) <www.dbrs.com>; Standard & Poor's "S&P says EU regulation should boost market confidence in ratings" (23 April 2009) Press Release < www2.standardandpoors.com>.

New Zealand could participate in experiences, other governments have made, and build on existing regulation, like the Canadian. One might argue, that regulation is not required where bigger markets like the United States have already imposed enhanced requirements on CRAs. The big three CRAs have therefore adopted new standards, at least "substantially" the IOSCO Code of Conduct. Yet, omitting to regulate is here not considered appropriate, as these standards are still not legally binding and enforceable in New Zealand. Own regulation helps around both this hurdle and the fact that the big three CRAs are Non-New Zealand companies. By enacting own regulation like the United States or the European Union, which requires overseas CRAs to register in order to provide their services, these rules become applicable even to these CRAs.

Accordingly, the regulation of CRAs in other countries is of interest. The author looks at the regulation in the United States, in the European Union, by briefly describing the implementation in the United Kingdom, and Australia due to its adjacency to New Zealand. Both Australia and the European Union have introduced new regulation, which came into effect on the 1 January 2010.¹⁵⁶ Indeed, the European Union as well as the United States are currently discussing amendments to their regulation.¹⁵⁷

B The Influence of the United States

The United States pioneered the regulation of CRAs. They passed appropriate legislation relatively early with the Credit Rating Agency Reform Act 2006. This Act combines a "comprehensive registration mechanism, ongoing oversight, and empowers the SEC to censure, limit, suspend or revoke registration of the NRSRO [Nationally Recognized Statistical Rating Organization]".¹⁵⁸ It is striking, though, that this piece of legislation was not adequate to prevent the collapse of the housing market in the United States, the origin of the Subprime Crisis.

Accordingly, the United States Government reviewed its regulation and passed in May 2010 the Senate's financial reform bill.¹⁵⁹ This Bill focuses on enhancing the oversight

¹⁵⁶ Regulation 1060/2009 on credit rating agencies [2009] OJ L 302; Corrigendum to Regulation 1060/2009 on credit rating agencies [2009] OJ L 350/59; Australian Securities and Investments Commission "ASIC outlines improvements to regulation of credit rating agencies in Australia" (12 November 2009) Press release <www.asic.gov.au/asic/>.

¹⁵⁷ Ibid; with regard to the United States see below IV B.

¹⁵⁸ Maris, above n 54, at 11; Deniz Coskun "Credit rating agencies in a post-Enron world: Congress revisits the NRSRO concept" (2008) 9(4) JBR 264-283.

¹⁵⁹ Restoring American Financial Stability Act of 2010 (US).

over CRAs. A new office within the SEC would deal with CRAs. Its powers would comprise the authority to fine CRAs in cases of misconduct and to examine CRAs "at least once a year". In addition, CRAs would be required to disclose more information and to improve internal control standards. Moreover, private investors would be entitled to sue CRAs for incorrect ratings directly.¹⁶⁰ Additional amendments have been made, inter alia, to establish a board as a middleman between issuers and CRAs. This board would be allocating a specific rating request to a rating agency of its choice, to both avoiding conflicts of interest between issuers and CRAs and enhancing independence.¹⁶¹

The United States is at least one step ahead of the rest of the world with their (suggested) regulation. This paper argues that this approach goes slightly over the top. The current proposal is a logical reaction on the Subprime Crisis and identified risks in relation to CRAs. Therefore the author welcomes the establishment of a new authority and enhanced disclosure standards. Yet, implementing a middleman, like the above board, interferes too vigorously with self-autonomy of CRAs and issuers. The idea of free markets is definitely jeopardized, if market participants have no longer a choice to contract.

C Comparison to the European Union

1 The European view on the regulation of CRAs and their approach

In late 2004 the view of the European Commission was that the existing directives "combined with self-regulation on the basis of International Organization of Securities Commission (IOSCO) Code" would be sufficient to deal adequately with all emerging issues.¹⁶² In the recent years the European Commission has performed a volte-face though, self-regulation has been not longer considered adequate "in face of the 2007 financial firestorm".¹⁶³ The current approach seems now to be largely influenced by the United States Credit Rating Agency Reform Act 2006 and the current reform bill.

In the European Union appropriate regulation was first enacted in September 2009 with the European Regulation on Credit Rating Agencies to harmonise the different approaches of European countries to deal with CRAs in the European Union.¹⁶⁴ The

¹⁶⁰ Ibid; Wolverson, above n 31, *ibid*.

¹⁶¹ Ibid.

¹⁶² Parker and Bake, above n 106, at 401; the existing directives referred to: the Market Abuse Directive (MAD) and the Capital Requirements Directive (CRD).

¹⁶³ Ibid, at 402.

¹⁶⁴ Regulation 1060/2009 on credit rating agencies [2009] OJ L 302.

Regulation lays down a couple of standards in relation to CRAs' behaviour and corporate governance.¹⁶⁵ In fact, the Regulation builds upon the IOSCO Code of Conduct, by addressing many issues which the IOSCO Code of Conduct already contains. Yet it goes even further in some points, by enhancing transparency and introducing supervision as well as by setting legally binding standards.¹⁶⁶

In detail, the Regulation establishes a registration system for credit rating agencies.¹⁶⁷ It further requires compliance with several standards in relation to independence, conflicts of interest, employees and analysts, methodologies and models, outsourcing, and disclosure and presentation of information.¹⁶⁸ Some financial institutions are only allowed to use credit ratings for regulatory purposes, if, in general, credit ratings have been issued by a properly registered CRA.¹⁶⁹ In cases of non-compliance, a withdrawal of the registration is possible.¹⁷⁰

Most recently the European Commission has gone a step further. Due to the latest "contribution" of CRAs to the bad situation in Greece and the destabilisation of the Euro, the European Commission is aiming at centralising the oversight of CRAs.¹⁷¹ The designated body might be the European Securities and Markets Authority (ESMA), which was established in 2009 and "is due to come into force at the start of 2011".¹⁷² Essential powers of this body would include a proper enforcement system for cases, if CRAs do not comply with their duties. For example, if there is a conflict of interest, the body would be entitled to issue a warning, fine the CRA or in the worst case withdraw the registration. Another important power would be to have the right to investigate and to perform inspections.¹⁷³

Due to its similarities, this approach seems to be aligned with the current strive of the United States to establish a separate body within the SEC with appropriate powers. In contrast to the United States though, the European Union is, besides, considering plans to "create a regional [European] credit rating agency". This specific CRA, being under the

¹⁶⁵ Parker and Bake, above n 106, *ibid*.

¹⁶⁶ See *ibid*; European Commission "Commission adopts proposal to regulate credit rating agencies" (12 November 2008) Press Release IP/08/1684 <www.ec.europa.eu>.

¹⁶⁷ Regulation 1060/2009 on credit rating agencies [2009] OJ L 302/14ff.

¹⁶⁸ Regulation 1060/2009 on credit rating agencies [2009] OJ L 302/23 (Annex 1).

¹⁶⁹ Regulation 1060/2009 on credit rating agencies [2009] OJ L 302/8ff.

¹⁷⁰ Regulation 1060/2009 on credit rating agencies [2009] OJ L 302/16.

¹⁷¹ The Financial Regulation Forum, above n 32, *ibid*.

¹⁷² *Ibid*; Bowen, above n 31, *ibid*.

¹⁷³ *Ibid*.

supervision of, for instance, the European Central Bank (ECB), could then compete with the big three and allegedly lead to more competition, not to forget more transparency.¹⁷⁴

Again, the author welcomes most of the regulatory measures, but by far not all. Similar to plans of the United States the plan of the European Union to set up their own CRA is a step in the wrong direction, clearly undermining the notion of competition. Despite a lack of competition in the "CRA market", artificial interventions by governments have to be avoided. Otherwise, theoretically, the ultimate consequence might be that each government establishes its own CRA. That is clearly far from desirable. This paper hence proposes another approach in order to open the market for more and other existing CRAs.¹⁷⁵ First, thresholds should be lowered, such as making it easier and less expensive for smaller CRAs to comply with regulation. Secondly, governments should admit more smaller CRAs to provide credit ratings for regulatory purposes.

2 *The implementation in the United Kingdom*

In the United Kingdom the Credit Rating Agencies Regulations 2010 came into force on 7 June 2010. According to the Regulations the responsible authority for CRAs in the United Kingdom is the Financial Services Authority (FSA)¹⁷⁶ This authority has, inter alia, the investigatory powers, described above.¹⁷⁷

The correspondent competent authority in New Zealand with comprehensive powers could be the announced new super regulator, the Financial Markets Authority (FMA), if the New Zealand Government finally decides to step in to regulate.

D *Comparison to Australia*

A look across the Tasman shows that Australia has aligned its regulation of CRAs with the IOSCO Code of Conduct and has tried to catch up with regulation in major markets, such as the United States or Europe.¹⁷⁸ The Australian regulation focuses on licencing of CRAs and is embedded in the Corporations Act 2001.¹⁷⁹

¹⁷⁴ Ibid.

¹⁷⁵ Bowen, above n 31, *ibid.*

¹⁷⁶ Regulation 1060/2009 on credit rating agencies [2009] OJ L 302/17.

¹⁷⁷ Regulation 1060/2009 on credit rating agencies [2009] OJ L 302/17 and 21.

¹⁷⁸ Australian Securities and Investments Commission, above n 156, *ibid.*

¹⁷⁹ *Ibid.*; Corporations Act 2001 (Australia).

CRAs are from 1 January 2010 required to hold an Australian Financial services (AFS) licence.¹⁸⁰ To comply with the “general licensee obligations”, CRAs must, *inter alia*:¹⁸¹ manage conflicts of interest that may arise; have adequate resources for the “nature, scale and complexity of their businesses”; ensure their employed credit analysts are highly trained and competent to prepare credit ratings; ensure best practice, provide credit rating services “efficiently, honestly and fairly”; and have risk management systems in place. Apart from these general obligations, CRAs must comply with a further requirement, if they provide credit ratings for investment products that are offered to consumers.¹⁸² In this case CRAs are required to implement a dispute resolution system. Another category of obligations, which the ASIC imposes on CRAs are specially tailored conditions. Examples are: the mandatory compliance with the IOSCO Code of Conduct, the disclosure of procedures, methodologies and assumptions for ratings and a review system of credit ratings.¹⁸³

Unlike the United States and the European Union, Australia seems to strike a balance between regulation and self-regulation, namely the rights at stake and the different interests of market participants. This is a fact, which this paper embraces. Australia shows a rather reluctant approach with regard to investigatory powers, but by requiring CRAs to implement the dispute resolution system, it pays particular attention to consumer rights.

E Conclusion

Governments worldwide tend to jettison the long dominating self-regulation of CRAs. The examples underpin the regulatory effort to introduce registration and supervision models, comprising efficient enforcement methods for cases of non-compliance. Undoubtedly, issues like conflicts of interest and transparency are identified and high on the agenda. In the long run newly announced or yet passed regulation aims at increased investor protection and stabilised financial markets. The author generally embraces this approach, but considers some measures suggested by the United States and the European Union a bit over the top. As a result New Zealand is well advised to orient itself towards Canada and in particular Australia with their more balanced approaches. Nevertheless,

¹⁸⁰ Ibid.

¹⁸¹ Ibid.

¹⁸² Ibid.

¹⁸³ Ibid.

the Government should be using the most experienced markets like the United States and the European Union as guidelines and finally aim at a sound degree of interference.

V Conclusion

This paper recommends the New Zealand Government to step in to regulate CRAs. The right approach to deal appropriately with CRAs has been questionable for a long time. Governments and regulators worldwide have discussed different options, reaching from self-regulation and the New Zealand "wait and see"- approach to comprehensive regulatory measures, as taken by the United States and the European Union. The author argues that self-regulation has clearly failed. The IOSCO Code of Conduct was a beginning, but inevitably lacks of a proper enforcement procedure.

New Zealand Guidelines for non-bank deposit takers, set up by the Reserve Bank of New Zealand, were a first short step in the right direction, but by far not sufficient to cope with the current issues and risks. Diverse fundamental rights and principles are impaired, in particular consumer protection and financial stability. They lastly justify New Zealand's interference. The Government is well advised to keep pace with the bigger markets in the United States and the European Union. Adopted regulation should be in essential points aligned with international approaches. Globalisation in financial markets demands for global regulatory consistency.

The Government should implement effective and legally binding regulatory measures. To meet this aim, regulation should be principally in accordance with the Australian and/or the Canadian requirements, CRAs have to: apply for a registration, which is revocable in cases of non-compliance with the following requirements; manage conflicts of interest; employ highly trained and competent staff; comply with enhanced information and transparency standards; ensure mandatory compliance with the IOSCO Code of Conduct; have a review system of credit ratings; and ensure best practice. Through the registration requirement, New Zealand is able to go around the hurdle, that most CRAs do not have their headquarters or even subsidiaries in New Zealand. In this way regulatory measures become legally binding and enforceable. The super-regulator FMA, as counterpart of the SEC and the ESMA, might be the competent body to deal with the resulting ongoing supervision of CRAs and enforcement of appropriate regulation.

However, the issues in relation to CRAs cannot be resolved solely with regulatory measures. The Government should broaden the view on other crucial factors, which this paper has identified: educational measures have to be implemented to increase financial

literacy of New Zealand's consumers; financial advisors and other sellers of investment products should also be facing stricter regulation, preventing a one-sided use of credit ratings for marketing and sale purposes.

This paper has identified a challenging task for the New Zealand Government to tailor appropriate regulation. Due to the tremendous relevance of CRAs for the public and the modern financial markets, effective, comprehensive and timely regulation is required.¹⁸⁴ The author agrees with Blaurock, saying that there is no room for laissez-faire, as market powers were not capable to fulfil their function and cope with the emerging risks adequately: "regulatory action is necessary".¹⁸⁵

¹⁸⁴ See Grote and Maruhn, above n 13, at 267.

¹⁸⁵ Uwe Blaurock, above n 20, at 37.

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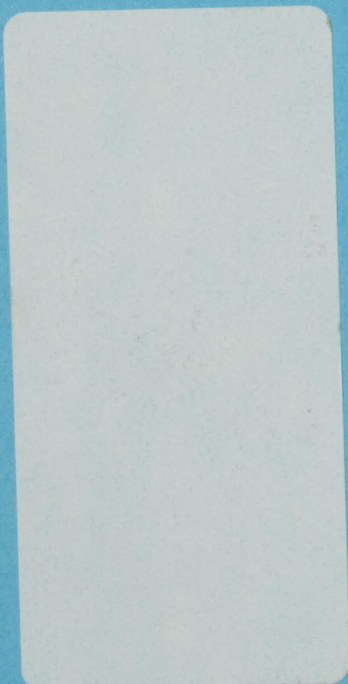
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