A Rating Agency in Maltese Financial Markets: Introduction and Implications

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Abstract

Credit rating agencies attempt to provide independent reports on the credit worthiness of a range of institutions, governments, public bodies, and international and domestic active companies. The study analyses the possible ways of introducing and establishing a rating agency in the Maltese financial markets and the benefits or otherwise for the financial market participants. It also identifies the regulatory setup for such an Agency. Twenty four personal in-depth semi-structured interviews were held with representatives of listed companies, stockbrokers and the Malta Stock Exchange. Three unstructured interviews were held with representatives of the Malta Financial Services Authority and two credit-standing companies. The study concludes that it is not the appropriate time to introduce a fully-fledged rating agency and make its services mandatory. The costs of obtaining a rating would probably discourage companies from listing. Also, immediate mandatory ratings might deter any prospective listing from abroad as companies may prefer to list on other exchanges where ratings are not mandatory. The Maltese market thus needs to be gradually prepared for the introduction of a rating agency regulated by the Maltese Authorities.

1. Introduction

In January 1991, the Malta Stock Exchange (MSE) came into being with the activation of most of the provisions of the MSE Act (Cap.345) 1990 and the appointment of a Council to head and direct the organisation. The MSE started its operations on January 8 1992 (Mallia, 2001). Through the provisions of the Financial Markets Act (Cap. 345) the MSE is no longer invested with a regulatory function, as this now falls under the responsibility of the Malta Financial Services Authority (MFSA).

Companies now have to satisfy both the by-laws and administration rules of the MSE and the listing rules of the MFSA in order to be admitted to listing on the MSE. However, one requirement that is missing in the Maltese scenario is a rating ratio.

Even though the MSE started its operations in 1992, to date Malta has no agency to rate securities listed or seeking to be listed on the MSE. Such a rating agency would be an independent organisation with no vested interest in the issuers, which can render objective judgments on the relative merits of the

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securities. By carefully analysing the issues in great detail, the rating agency in effect performs credit analysis for the investor.

A study of the possibility of introducing a rating agency was therefore felt opportune in particular following the expansion of the local financial market and in the light that Malta has joined the European Union.

This paper deals with the possible ways of introducing and establishing a rating agency in the Maltese financial markets, analyses the benefits or otherwise to the financial market participants and tries to identify the regulatory setup for such an Agency.

The rest of this paper is divided into five main sections. The first section summarises the relevant literature. The second section discusses the methodology used in the study. The third section presents the results of the findings. The fourth section discusses the findings and the final section concludes the study and presents its limitation.

2. Literature review

Ratings are assessments of the likelihood that bond holders will receive timely payment of interest and ultimate payment of principal by the rated final distribution date of a deal - some period of time beyond the last maturity date of loans (Forti, Weinberger, Gottlieb, Seen & Hamilton 2002).

The rating agencies have briefings and access to information not available to investors, financial analysts, investing institutions and lending institutions (McDowell, 2001).

Rating procedures at the larger credit rating agencies are designed to facilitate analytical consistency and capitalise on area expertise. Organisationally, the larger rating agencies divide the rating universe into separate categories by industry and type of instrument. At the core of the rating process is the rating committee (U.S. SEC, 2003). Rating committees are generally formed ad hoc to initiate, withdraw, or change a rating.

Rating agencies generally designate ratings of long-term debt through some variation of an alphabetical combination of lower and upper case letters. Fitch and S&P use the same ranking designators: AAA, AA, A, and BBB are investment grade categories; BB, B, CCC, CC, C, and D are considered speculative grade rankings. Moody's long-term rating designators are: investment grade: Aaa, Aa, A, Baa, speculative grade: Ba, B, Caa, Ca, and C. Rating agencies often attach modifiers to the grades to further distinguish and rank ratings within each generic classification (U.S. SEC, 2003).

Issuers seek credit ratings for a number of reasons, such as to improve the marketability or pricing of their financial obligations, or to satisfy investors, lenders, or counterparties, who want to enhance management responsibility. Public or private credit ratings may be sought from one or more rating agencies. In certain markets, such as the U.S. long-term corporate debt market, a single-rated debt issue may be priced below an issue with similar ratings from two agencies, because the absence of a second rating is interpreted as the issuer's inability to obtain another equivalent rating (Inside Moody's, 2003). In other markets, however, such as the asset-backed securities market, a single rating may be adequate confirmation of asset quality.

The widespread use of 'ratings triggers' in financial contracts recently has received considerable attention as a result of certain high-profile bankruptcies, such as Enron and Pacific Gas and Electric
Company (PG&E) (Inside Moody's, 2003). In the case of Enron, the use of credit ratings as “triggers” in trading and other financial agreements gave counterparties the right to demand cash collateral and lenders the right to demand repayment of outstanding loans, once Enron’s credit rating declined to certain levels. As a result, the existence of ratings triggers contributed to Enron’s financial difficulties.

Similarly, the impact of credit rating downgrades on PG&E’s financial agreements limited its ability to borrow funds to repay its short-term debt obligations. In cases such as these, contractual ratings triggers can seriously escalate liquidity problems to firms faced with a deteriorating financial outlook (Lamb & Sondhi, 2002).

In a November 2002 Association of Financial Professionals (AFP) survey, financial professionals found that credit ratings are often inaccurate and slow to reflect changes in company finances (AFP, 2002). In response to its survey, AFP has strongly urged the Securities and Exchange Commission (SEC) to focus on its oversight of credit rating agencies and foster greater competition among them, which will help restore public and investor confidence in the capital markets.

In a move designed to restore confidence in the credit rating process, three prominent global treasury and corporate finance associations announced the release of an Exposure Draft of a “Code of Standard Practices for Participants in the Credit Rating Process.” (AFP, 2004). The Code of Standard Practices is designed to restore confidence among issuers, credit rating agencies, investors and the regulators who oversee the credit rating process by creating enhanced transparency, protecting non-public information, guarding against conflicts of interest, and improving communications with market participants.

Credit rating agencies are subject to agency problems, since rating fees paid by issuers comprise their principal source of revenue. Ratings are particularly vulnerable in some of the least transparent instruments of the capital markets. In such cases, the rating agencies added a perspective not available from public sources information gained from direct (often privileged) contact with the issuer management by experiences analysts, who know which questions to ask (McDowall, 2001).

It is equally clear that a reputation for technical competence, continuity, transparency, objectivity and impartiality comprises the principal asset of the rating agencies, without which there would be no justifiable demand for their ratings. Consequently, this dependence on reputation has become the principal market-driven safeguard against exploitation of any potential conflict of interest in the ratings business. The fact that the two leading rating agencies, Standard & Poor’s and Moody’s, have between them an 80% share of the market for credit ratings also (Smith and Walter, 2001) suggests that the marginal temptations to offer improved ratings for reduced fees (to get the ratings mandate) is unnecessary and totally out of proportion to the costs to the firm of serious damage to its reputation.

One nagging question is whether an issuer that is subject to an unsolicited rating of one of its issues is driven to negotiate a solicited rating in return for a fee and the hope that such a rating will be more favourable. However, in most unsolicited ratings the issuer does in fact participate. According to Moody’s, a misperception has persisted that their unsolicited ratings are assigned without the benefit of issuer participation, whereas in the vast majority of cases issuers have in fact participated in the rating process (Landler, 1999). Moody’s designates each unsolicited rating as such in the respective press release. S&P issues an index relying on an issuer’s public information and other information in the public domain referred to as pi ratings, which are not based on confidential corporate information supplied by the issuer’s management and are reviewed each year based on new financial information. They may also be triggered by a material event affecting the issuer’s credit standing. S&P’s pi ratings are not subject to shading or re-rating watch lists.
The rating agencies are already under pressure from regulators on both sides of the Atlantic following criticism that they had failed to spot problems at Enron, WorldCom and Parmalat. Now there are signs that commercial pressures are on the increase as the derivatives markets grow in sophistication. Credit default swaps (CDSs) frequently pick up shifts in sentiment before the equities markets and long before they are reflected in the ratings provided by the agencies (Batchelor, 2004).

The unique characteristics of CDS offer benefits to a range of participants in the credit markets. These instruments may also offer investors higher returns for assuming very similar credit risk positions, e.g. as an alternative to a direct bond investment - as such, CDS can present new opportunities to relative-value investors (Bowen, 2003).

Since unlimited numbers of CDSs can be written on the bonds and loans for which they provide cover, the market is often more liquid than the underlying cash securities. CDS prices are seen as a purer reflection of credit quality. The sensitivity of the CDS market and the speed with which it responds are seen by some as a possible replacement for the rating agencies. At the very least “CDSs are the third rating agency”, said one senior fixed income banker, referring to the primacy of Standard & Poor’s and Moody’s Investors Service (Batchelor, 2004).

Both the credit default swap for a company and the company’s credit rating are driven by credit quality, which is an unobservable attribute of the company. Credit spreads change more or less continuously whereas credit ratings change discretely. If both were based on the same information we would expect rating changes to lag credit spread changes. As explained by Cantor and Mann (2003), quoted in Hull, Predescu, White & Rotman (2004), rating agencies have stability as one of their objectives. This stability objective is also likely to cause rating changes to lag credit spread changes. However, rating agencies base their ratings on many different sources of information, some of which are not in the public domain.

Support for the continuing role of the rating agencies comes from the latest Bank for International Settlements quarterly report, which was published in June 2004. The report found that “careful analysis of the impact of rating announcement on credit default swap prices for a broad range of issuers confirms that credit rating do convey information to market participants.” (Batchelor, 2004).

Doubts have also been cast on both the liquidity and timeliness of CDS price movements by other studies (Batchelor, 2004). There is no doubt that the developments of a credit risk market, which barely existed ten years ago, is causing some participants to question the role of rating agencies.

3. Research methodology

Twenty-four semi-structured interviews were held with thirteen companies out of the fifteen listed on the MSE, ten stockbrokers out of the twelve registered with the MSE and with a representative of the MSE. The interviews conducted with the MFSA and the representatives of the two credit standing companies were in the form of unstructured interviews, so as to be able to assess these participants’ position regarding the introduction of a credit rating agency. Two interviews were conducted with the representative of the MFSA. One was conducted in early 2004 and the other one in August 2004. The objectives of both the semi-structured and unstructured interviews were to enable the participants to express their views openly, thus better bringing to light their perceptions. The questionnaire for the semi-structured interviews contained 21 statements and was divided into three sections. The first section focused on the introduction and establishment of a rating agency in the Maltese financial market. The second section considered the benefits or otherwise to the financial market participants and the last section covered the regulatory setup.
4. Research findings

4.1 Response of the semi-structured interviews

The paper will start by presenting the findings from the semi-structured interviews. The findings will be divided into three sections. Section one will deal with the introduction and establishment of a rating agency. The next section speaks about the benefits or otherwise to financial market participants and the last section refers to the possible regulatory set-up.

4.2 Introduction and establishment of a rating agency

The first question enquired as to whether the Maltese financial market was structurally and/or culturally prepared for the introduction of a Maltese credit rating agency. Most of the participants, with the exception of the MSE representative interviewed, agreed that the Maltese financial market was culturally prepared for the introduction of a credit rating agency. However, while the stockbrokers were of the opinion that our Maltese market was not structurally prepared for such an introduction, the companies interviewed thought otherwise. The MSE representative stated that our market was so far neither culturally nor structurally prepared for the introduction of such an agency.

The next question dealt with the issue of whether such a rating agency should be a private company or instituted by public authorities. Participants, except for the MSE representative agreed that if a Maltese rating agency were to be established this should be a private institution and not a public one. However, the MSE believed such a new agency should initially be a public one.

Participants were then asked which functions of a Maltese rating agency would be more desirable. Most of the companies preferred to see it offer only the services of a rating index. On the other hand, the rest of the participants were of the opinion that such an agency should also offer other services, such as market updates and guidance, industry comparisons both in the Maltese market and also comparisons with other foreign companies, rating actions, credit polices, analyst views, press release, credit trend and company financial events.

The next question enquired as to whether a rating agency led to more transparency and scrutiny and thus to better investor protection. Most participants agreed that a rating agency, should lead to more transparency and closer scrutiny. This would create an environment offering better investor protection. When asked if they preferred a local or a foreign rating agency participants differed on their preference. Most stockbrokers interviewed preferred that Maltese companies obtained a rating from a foreign rating agency (rather than having a rating agency established in the Maltese market) while most companies and the MSE favoured the establishment of a Maltese rating agency as this would give the local market more credibility.

The next question asked for respondents’ opinions regarding the strengths and weaknesses of a Maltese rating agency. Most stockbrokers stated that a Maltese agency may have limited strengths, yet they still believed that it would be able to foster a sense of market information and confidence for investors and institutions. The latter opinion was shared by the rest of the participants who believed that a Maltese agency would improve the image of both the parent company and all its subsidiaries in that they would be able to obtain better credit terms.

On the other hand, most respondents referred to Malta’s size as one of the greatest weaknesses. Two other questions dealt with the different opinions with regards to the criteria to be adopted by a
Maltese rating agency and with its essential characteristics. Participants were of the opinion that the criteria to be used by an eventual Maltese agency should be the same as the criteria used by internationally renowned agencies. In essence, all participants agreed that the essential characteristics for a Maltese agency would be transparency, independence, high integrity and credibility in its criteria for rating used, with good standards and appropriate credentials.

Views on the possibility that credit default swaps would be a desired alternative to a credit rating agency were considered in the next question. Participants stated that credit default swaps were not a substitute to a credit rating agency but were something completely different.

4.3 Benefits or otherwise to financial market participants

Whether the ongoing costs of rating are a detriment to the issue of securities is dealt with in the first question of this section. The majority of participants, except companies, were of the opinion that the ongoing costs of rating would be detrimental to the issue of securities. Most companies believed that if the cost of rating would be reasonable in comparison to the other costs they had to undergo, this should not create a problem. The next question asked whether such a Maltese rating agency would be perceived as financially viable and whether companies should be assisted to counteract rating costs. All participants agreed that given the Maltese markets' small volume, it was difficult for a rating agency to be established and be profitable, unless the cost of rating was very high, which would make it prohibitive in attaining a rating. Yet the majority of respondents stated that companies should not be assisted to counteract rating costs.

The next question enquired about the relevance of three specified factors in inducing investors to subscribe for a bond issue. The results are presented in Table 1. Participants agreed to a varying degree that the Maltese investor attaches a lot of importance to the interest rate offered. After looking at the interest rate offered, investors also place importance in the credit standing of the issuer.

Table 1: Relevance of factors inducing investors to subscribe for a bond issue

<table>
<thead>
<tr>
<th></th>
<th>Total n=24</th>
<th>Stockbrokers n=10</th>
<th>Companies n=13</th>
<th>Stock Exchange n=1</th>
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<tr>
<td></td>
<td>Mean</td>
<td>St Dev.</td>
<td>Mean</td>
<td>St Dev.</td>
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<tr>
<td>Interest rate offered</td>
<td>5.54</td>
<td>0.779</td>
<td>5.70</td>
<td>0.675</td>
</tr>
<tr>
<td>The risk associated with such an investment</td>
<td>4.38</td>
<td>1.408</td>
<td>4.00</td>
<td>1.414</td>
</tr>
<tr>
<td>The credit standing of the company making the issues</td>
<td>4.13</td>
<td>1.484</td>
<td>4.00</td>
<td>1.491</td>
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Ranking 1 to 6, 6 being the highest

The views of the participants with regards to the extent that a rating index would affect investors' perception in the relevant security are dealt with in the following question. Most participants were of the opinion that a rating index would affect investors' perceptions in the relevant security significantly.
The next question enquired about the different opinions when deciding whether we should have a Maltese rating agency versus a foreign rating agency or a Nationally-Recognised Statistical Rating Organisation (NRSRO), for example Moody’s or Fitch. Almost all participants of the study stated that they would prefer a rating provided by an affiliate of an NRSRO. The next questions probed the way forward in case of a negative rating and enquired whether participants considered rating to be beneficial. Most participants of the study stated that a negative rating would drive a company to find alternative methods of financing. Furthermore, they agreed that overall rating is beneficial.

### 4.4 Possible regulatory setup

The first question in this section asked respondents on their preference as to whether a rating agency should be unregulated, publicly regulated, self-regulated, or a mixture between publicly and self-regulated. Table 2 shows respondents preferences as to regulation types for the rating agency. The majority of the companies interviewed would prefer the functions of a Maltese agency to be publicly regulated. The stockbrokers seemed to be equally divided between public and self-regulation. The MSE would prefer a Maltese rating agency to be self-regulated.

**Table 2: Types of regulation for a Maltese Rating Agency.**

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<th></th>
<th>Total n:24</th>
<th>Stockbrokers n:10</th>
<th>Companies n:13</th>
<th>Stock Exchange n:1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Publicly Regulated</td>
<td>13</td>
<td>3</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>Self-Regulated</td>
<td>6</td>
<td>3</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Both Publicly and Self-Regulated</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Not Regulated</td>
<td>2</td>
<td>2</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>24</strong></td>
<td><strong>10</strong></td>
<td><strong>13</strong></td>
<td><strong>1</strong></td>
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</table>

When asked if rating agencies should be liable to damages for companies that failed following a favourable rating, participants were of the opinion that they should not be considered liable.

The next question asked whether ratings needed to be made mandatory. The majority of stockbrokers and the MSE agreed that rating had to remain non-mandatory. On the other hand, companies interviewed stated that rating should be part of the listing rules and mandatory.

Whether Malta’s accession to the EU had any bearing on the need for a rating agency was dealt with in the last question. Most participants were of the opinion that Malta’s accession to the EU did not have a bearing on the need for a rating agency, while the MSE thought otherwise.

### 5. Response of the unstructured interviews

The paper will now portray the findings of the unstructured interviews. The MFSA had been debating the issue of whether to introduce the concept of a rating index for Maltese listed companies.

Initially the MFSA had two options to debate and decide upon. First it wanted to try and make an agreement with a foreign rating agency which would provide Maltese companies with a preliminary
rating. The second possibility was to enforce sinking funds. While the debate was ongoing the tendency was to move towards establishing a sinking fund.

Later on the Listing Committee considered whether it should enforce ratings. The dilemma that faced the MFSA is that in no country was a rating made mandatory and they were afraid that by making ratings mandatory they would be limiting business. The Listing Committee finally expressed the view that the MFSA should at this point insist with licensed investment advisers to analyse fully the risk elements resulting from the published information available and should invest in investor education.

In Malta, there are currently two entities that provide credit assurance services. Both of them were in favour of a Maltese rating agency and did not exclude the possibility of extending their services to that of a full credit rating agency. One of them was of the opinion that in order for a Maltese credit rating agency to be established, it must possess a good database on all companies similar to the one his entity had already set up.

6. Discussion of findings

The overwhelming response to initial public offerings (IPOs) in Malta to date indicates that investment decisions are usually taken on the basis of the reputation of the issuer and coupon rate being given. Investors are mostly interested in gaining a large return for their investment. They little seem to equate higher coupon rates with higher risks.

Secondary market activity is also indicative of the thinking of the Maltese investor. While it is rational for investors to buy low and sell high, Maltese investors do not yet seem to be ready to risk enough to buy securities when low, this implying that a real risk culture is as yet not clearly established.

It is reasonable to argue that when a country, corporate body or financial institution borrows from investors, it is difficult for the potential bond holder to individually assess the borrower’s risk of default and in such circumstances a credit rating agency may play an important role by collecting information about the issuer and sharing it with the investors, thus providing such investors with a minimum standard of protection.

However, improving the level of such protection is not an agency’s only function and definitely not the only reason why it needs to be established. In carrying out its work the agency will distinguish between the financial stability of different companies enabling sounder companies to issue bonds at a lower coupon, and thus facilitating a fairer and more stable market. An agency will also help the dissemination of information, thus reducing the effect of rumours and speculation weeding out unnecessary share fluctuations and making it more difficult for ‘weak’ issues to make it to the stock exchange. Hopefully more stock market efficiency will benefit both investors and issuers.

In addition, foreign investors will probably take a stronger interest in the Maltese market particularly in those companies which manage to obtain a good rating. In itself, such a rating will help to encourage companies to offer bonds to the public. Also, a rating will probably help companies - particularly large ones - to improve their credit terms with foreign suppliers.

As already mentioned, the use of instruments such as credit default swaps may be considered as an alternative to obtaining a rating. However, the Maltese market is still largely under-developed and it would be probably extremely difficult in the foreseeable future to introduce such swaps in practice given the prevailing lack of depth and liquidity.
Factors such as the size and type of issue, the targeted investors, the size of the projected issue and the current and projected market performance need to be taken into consideration in gauging the cost effectiveness for any company obtaining a rating. The expense may be potentially beneficial if a company is eyeing the foreign market. In any case, the cost of a rating index needs to be kept reasonable in comparison to other listing costs.

For the rating process to become possible and viable, a minimum number of analysts and professional staff as well as a company quotation on the stock exchange are required. For such an activity to be economically viable with its administrative and operational infrastructure, its charging to companies would have to be relatively expensive in relation to total listing costs and this therefore discourages companies from participating. These considerations would probably put off the Maltese private sector from setting up such an agency. Perhaps one possibility is for such business to be carried out by a Maltese affiliate of an already established international rating agency. In addition to economies of scale in respect to the required information there would thus be greater likelihood of quick international recognition for a rating given by such a set-up. At the same time, the Maltese base would hopefully help to keep down the service charges, while also rendering the index more relevant to the environment in which Maltese companies are operating.

On the basis of the single European market, if a credit rating agency were to be introduced in Malta, it would definitely have to equate its ratings with those applicable in other European markets. The criteria will therefore have to be internationally acceptable and therefore basically comparable with those obtained elsewhere in Europe. However, the downside to this is that it will probably be difficult for such an agency to assign the minimum acceptable rating to the companies already listed on the MSE. Malta as a country has an 'A' rating and as such it is considered somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than countries with higher ratings. It is difficult to envisage Maltese companies obtaining higher ratings than the country's rating. Using Fitch's rating definitions a BBB rating is still considered as investment grade and a company with such a rating is considered as being able to meet adequately its financial commitments. However, adverse changes in circumstances and in economic conditions are most likely to impair a company's capacity pushing down the rating to lower and riskier favourable levels.

The question of whether a Maltese rating agency should be privately or publicly instituted is not easily answered. One may tend to agree that initially it will be more beneficial to the Maltese market to have a rating agency which is established by the public authorities or by an entity which includes both private and public elements. The fact that a rating agency is instituted by public authorities may add to its credibility and encourage companies to work towards a rating. Subsequently, as the Maltese market gains confidence in ratings, enterprising individuals might consider setting up a private rating agency. The most important and fundamental characteristic of a rating agency, whether publicly or privately instituted, is that it always remains independent. Yet in a small scenario, it is probable even more difficult for a completely private rating agency to appear and in fact be independent.

The independence of private entities has already been challenged in other countries such as the USA, and one reason for this is that credit rating agencies are seen to be subject to agency problems, since rating fees paid by issuers comprise their principal source of revenue. One possible counter-argument to this is that similar arrangements apply in other sectors, such as in the case of fees being paid by the clients of audit firms themselves. On the same line of reasoning the independence of the audit firms would also become highly questionable. What is clearly imperative is that a Maltese rating agency needs to have analysts with a clean reputation for technical competence, continuity, transparency, objectivity and impartiality because it is similar qualities which justify demand for ratings. Such a dependence on reputation remains the principal market-driven safeguard against the exploitation of
any potential conflict of interest in the business, as in any other businesses offering financial services.

One clear safeguard of public participation in Malta is that against possible conflicts of interest. In view of the smallness of the country, it cannot be easily stated here as elsewhere that no single issuer has or may have a material economic influence on a rating agency. Any particular listed company may make a large difference in terms of the profits to the rating agency thus rendering the conflict possible. Therefore, only making ratings mandatory and thus leaving listed companies with no option but to rate would help remove such possibility of conflict of interest.

While rating agencies in other countries offer a variety of other services apart from the rating index, in its initial stages, a Maltese rating agency would probably be able to offer only the service of such rating index before gradually extending this to other services. Additionally, when such extensions become possible, proper Chinese walls will need to be set up. The provision of ancillary advisory and other business services has its own problems of independence for agencies and their clients. For example, a credit-rating decision may be impacted by whether or not an issuer purchases additional services offered by the agency. Any moves towards providing other services needs therefore to be cautious if rating success is to be ensured.

Another issue which public participation in a credit rating agency can safeguard against is that of unsolicited ratings. Issuing ratings on published information only, as is normally done in case of unsolicited ratings could be very misleading as the agency would not necessarily have full insight into the goings-on-of the company. Besides the unfairness of the results such rating might potentially force issuers to negotiate a solicited rating in return for a fee in the hope that such a rating will be more favorable.

The functions of a Maltese rating agency would need to be regulated by the Maltese authorities as is the case for many other professional services. The Maltese rating agency would be subject to regulation aimed at ensuring investor protection and fairness and consistency in rating standards. In this connection, model standards have already been carried out by three prominent global treasury and corporate finance associations in the USA in a move to restore confidence in the credit rating process.

Investors should be able to sue the rating agency on the grounds of negligence and fraud. However, the Maltese rating agency will not be made automatically liable, by a provision in the legislation, for companies who fail subsequent to a favourable rating.

The question remains whether ratings should be made mandatory or not. On the one hand mandatory ratings would probably create sufficient demand for a Maltese established rating agency. On the other hand, however, the mandatory ratings may also easily discourage new issuers. Additionally even though it seems that unless ratings are made mandatory too few companies will opt for a rating a more important consideration is that it will be a disincentive for companies to come forward to seek a listing in the first place. In particular, prospective listings from abroad may be postponed or even transferred to other exchanges where ratings are not mandatory.

Overall, a chicken-egg syndrome seems to prevail with respect to the introduction of a rating agency. Should one introduce a rating agency first so issuers may gain more confidence in the market or should one rather encourage more listing in the first place before introducing a rating agency? However, there is clearly a problem with the first course of action in that rating agencies work best if the market is already developed, in which scenario they will be able to make sensible and needed comparisons of similar companies in the same sector. The concept of rating would therefore be largely lost. Perhaps there is no real alternative but to prepare our market gradually for the introduction of such an agency.
7. Conclusion

An important issue to keep in mind is the need to take measures to enhance the Maltese market. In order to introduce a rating agency in Malta it is important that the Maltese authorities must first provide the regulatory framework in which such an agency would operate. This would ensure better investor protection and give more credibility to the credit rating agency. On the basis of the single European market, if Malta were to introduce a Maltese credit rating agency, it would definitely have to equate Maltese ratings with those that apply in other European markets. However these criteria must take into consideration the Maltese socio-economic environment. There is the fear that if the Maltese credit rating agency were to adopt criteria used abroad, the Maltese credit rating agency will find it difficult even to assign an acceptable rating to the companies already listed on the Malta Stock Exchange.

Initially a rating agency could be established by the MFSA in a joint effort with the private sector. In order to start encouraging companies to get a credit rating, the MFSA could consider subsidising the costs of the credit rating agency. In this way, the cost to the issuers will not be too high when compared to the other costs of listing. The rating index should not be mandatory but optional, so as not to discourage foreign investment. The credit rating agency will make the market more efficient and in this way it will encourage more companies to list and existing companies to offer bonds more frequently. Gradually the credit rating agency will start to function more efficiently thus reducing the requirement for the MFSA to subsidise its activities. In due course the rating agency would be left to function privately but under the monitoring and scrutiny of the MFSA.

The results of this study are subject to a number of limitations. The study focuses primarily on investors represented by the stockbrokers, issuers and Maltese authorities' views on the introduction of a Maltese credit rating agency. It analyses the needs, fears and opinions of these market players. The study is limited in that it will not go into the detailed financial analysis for establishing such a rating agency, such as the number of analysts and costing.

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