Framework for Country Reclassification in the MSCI Global Equity Indices

Consultation Document
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About the consultation

Introduction

- The primary objective of this consultation is to solicit feedback on certain enhancements to the process of reclassification of a country from the emerging to the developed market indices, and in particular to understand the investment process needs of market participants with regards to the role and timing of each phase in the process.
- We are also providing an expanded description of the factors that MSCI considers in the analysis of a country's status as emerging or developed. This expanded description does not represent any fundamental change and the guiding principles remain the same. We welcome feedback on these factors.
- For the sake of simplicity, this consultation focuses on the reclassification of countries from the emerging to the developed market indices. However, please note that some of the issues raised by the existing process and the enhancements discussed also apply to the process for addition, removal or large weight changes of countries.
- Note that the consultation may or may not lead to the adoption, in whole or in part, of the enhancements described herein and importantly may not lead to any change to the current process.

I. The Process

Current process for country reclassification

- MSCI regularly monitors countries internally, and for those countries that make significant progress, MSCI conducts ongoing more intensive research and analysis.
- Public communication with regards to a potential country reclassification has two main stages:
- Stage 1: MSCI announces the opening of a formal review of a country's status through a consultation if MSCI's internal analysis concludes that a change in the country's classification may be warranted. The consultation with investors worldwide aims to solicit views based on each investor's specific experience and market knowledge regarding where the country stands with respect to the relevant factors.
- Stage 2: MSCI makes a public announcement regarding its final decision on a country's status. If a change is warranted, the final announcement specifies the implementation details. MSCI ensures that sufficient lead time is given to investors. Changes may be implemented in several phases if needed.

Potential issues with the current process

- A perceived lack of transparency in MSCI's current reclassification process may result from the following:
  - The communication and dialogue with investors, in the form of a formal review through a consultation, starts only after MSCI concludes through a detailed internal (non-public) analysis that a change in a country's status may be warranted.
  - As a result, in the current framework, prior to the formal review and consultation, investors cannot distinguish between emerging markets that, in MSCI's assessment, are further along in their development, and those that are not.
- Additionally, investors may consider the formal review and the consultation as potentially occurring too late in the process.

Proposed enhancements

- The proposal is to make a clearer distinction between the public formal review and the consultation and to start the formal review at an earlier stage.

- The formal review would consist of regular contacts with investors, other market participants and expert organizations in order to seek input and insights to further advance internal research and analysis. MSCI would open a formal review for a country that is further along in its development, and that is expected to become a candidate at one point in time, but for which no conclusion has yet been reached that a reclassification is warranted.

- The purpose of the consultation would be to gather feedback on a formal proposal from MSCI with regards to a country reclassification. A consultation would take place only if the conclusions from MSCI's formal review indicate that a reclassification is warranted.

Proposed enhancements

- As an example, MSCI announced that the status of Greece was under formal review for a potential reclassification from the emerging to the developed indices on March 28, 2000. A public investor consultation was conducted in parallel. De facto, the formal review coincided with the public investor consultation. MSCI's final decision was announced on July 31, 2000, 4 months after the first announcement.

- The proposal would have the advantage of allowing for more interactions and free exchange of views between MSCI and market participants before deciding on the start of a formal consultation.

Proposed enhancements

- In this framework, there will be three phases:
  - Phase I: the public formal review
  - Phase II: the formal consultation, assuming one is warranted and
  - Phase III: MSCI's final announcement
- The length of time of each of these phases may have important implications and may require some further considerations.

Proposed enhancements

Timeframe discussion

- Currently, the length of time between the start of a consultation and the final announcement generally is three to six months and a lead time of at least six months is typically provided to investors before the implementation of a change.

- One of the important questions related to the potential enhancement is the length of time that a public formal review remains open before a formal consultation would be launched.

- Allowing for sufficient time is important for MSCI to conclude its research, but more importantly for market participants to assess the investment process implications of a country being considered for a reclassification from the emerging to the developed market indices.

Potential enhancements

Timeframe discussion

- If a short timeframe is sufficient, MSCI could wait until the evidence is stronger that a country is a serious candidate for a reclassification before announcing a public formal review.
- On the other hand, if the investment processes of market participants require a longer timeframe, then MSCI could announce the start of a formal review much earlier and potentially when more uncertainties still remain.

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Potential enhancements

Timeframe discussion

- We can distinguish between two main timeframe scenarios:
  - A reasonably short timeframe, for example 1 to 1 ½ years before the opening of a consultation, if one is warranted
  - A longer timeframe, for example 2 to 3 years before the opening of a consultation, if one is warranted

Potential enhancements

A short timeframe

- Pros:
  - The start of the public formal review would indicate that the country is a very strong candidate for reclassification.
- Cons:
  - Implies that the bulk of the research would have been concluded internally before the start of the public formal review, thus potentially creating the impression of a lack of transparency
  - While powerful, the indication that a country is a strong candidate may be considered as coming too late in the process.

Potential enhancements

A longer timeframe

- Pros:
  - Would allow MSCI to better judge the level of development achieved and the commitment to reforms while a free exchange of views with market participants continues
  - Would provide an earlier indication of a potential reclassification and thus improve transparency.

- Cons:
  - Countries could be placed under review at an earlier stage of development where greater uncertainties with regards to the country re-classification remain, potentially creating confusion for market participants.
  - A three-year framework may be considered to be too long to be a really useful indication from an investment process perspective.

Handling of transition issues

- The various aspects of the transition of a country from the emerging to the developed market indices should be taken into consideration.

- The transition of a country can be implemented in various ways. For example, the transition of several countries can be made to coincide, rather than re-classify or add a new country independently, solely based on its individual merits.

- Also, in recent years, MSCI has implemented large changes in different phases to facilitate the transition. In the case of a re-classification, this implies that a country can be simultaneously in the World (Developed) and Emerging Markets Indices.

II. Determining factors for country reclassification

Relevance of EM/DM segregation

- As stated earlier, the purpose of this section is to expand the description of the factors used by MSCI in the country classification analysis.
- MSCI has explored various alternatives to the current division of countries between emerging and developed, and also to the methodology used to classify countries, ranging from a pure quantitative approach to a pure qualitative approach.
- The conclusions are:
  - The classification of countries between emerging and developed is still representative of the dominant investment process.
  - Qualitative analysis, supported by some quantitative references when appropriate, remains essential due to the multi-dimensional nature of the decision to classify a country as developed or emerging.
- The factors that should be considered in the analysis of the potential reclassification of a country are described in the following pages.

General principles for country reclassification

- A country currently included in the MSCI EM Index would not be re-classified to the developed market indices unless it demonstrates that its economic development is sustainable, that it has an advanced capital market and that its institutional and legal framework is robust.
- In addition, no major political risk should be associated with that country and the market participants' perception should support the decision to reclassify the country to developed market status.
- The analysis should conclude that these developments and resulting characteristics are irreversible in order to ensure that the change in classification is warranted.

Re-classification of countries

Sustainability of economic development

- Macro-economic stability
  - The nature of past and current economic performance and especially its stability is an important consideration. A reasonable historical economic stability is an important indication for future sustainable economic development.
  - Factors looked at include, but are not limited to: level and evolution of GNI per capita, volatility of GDP growth and of exchange rates, past levels of inflation, trade characteristics, real exchange rate.

- Current state of the economy and projections
  - Future stability is also conditioned by sound fiscal and monetary policies.
  - Factors looked at include, but are not limited to: fiscal and monetary policy, inflation, fiscal deficit, public and corporate debt.

Re-classification of countries

Sustainability of economic development (Continued)

- Involvement of the government in the economy
  - The degree and the nature of the involvement of the government in the management of the country economy is an important consideration.
  - On one side, the commitment of a government to reforms and restructuring, the setting of clear road maps and the effective implementation of the road map is an important and positive indication for investors as it brings visibility for long term investments.
  - On the other side, the fact that some governments still exercise some control on the economy, through various protective measures or exchange rate control, can be an indication that they are still concerned about the resilience of the country economy and/or that they are not fully committed to a market economy.

Re-classification of countries

Sustainability of economic development (Continued)

- Health of the financial system, of the corporate sector and households

  - Particular attention is paid to the strength of the country's financial system which is an essential element of stability. The health of the country's corporate sector is also looked at with a focus on debt, solvency and profitability.

  - Factors looked at include, but are not limited to:

    Financial system:
    - Traditional performance and capital adequacy ratios
    - Prospective analysis provided by rating agencies on the health and soundness of the banking system
    - Leverage
    - Efficiency ratios

    Corporate sector:
    - Corporate debt, also relative to GDP, and solvency
    - Rate of business creation and bankruptcy
    - For bank: non performing loans, capital adequacy ratio

    Households
    - Level of household credit as a fraction of GDP and its evolution
    - Credit card delinquency ratio and delinquency rate.

Re-classification of countries

Development and quality of the market structure and legal framework

- Investability
  - The degree of openness of a country and ease of access to the capital markets is fundamental
  - Factors looked at include, but are not limited to
    - Requirements for inflows and outflows of capital
    - Investor registration process
    - Existence of foreign ownership limits
    - Absolute level of liquidity
    - Liquidity distribution across market capitalization
    - Size of the market
    - Size distribution
    - Breadth of the market.

Re-classification of countries

Development and quality of the market structure and legal framework (continued)

- Business Environment
  - Factors looked at include, but are not limited to:
    - Adequacy and transparency of the legal and regulatory system
    - Level of observance and the fair application of the law
    - Control of corruption
    - Adequate corporate governance
    - Protection of shareholders, including minority and foreign shareholders.

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Re-classification of countries

Development and quality of the market structure and legal framework

- Financial Markets Operational Efficiency
  - The investment conditions and ease of trading in a given market are important pre-requisites for a market to qualify as developed.
  - Factors looked at include, but are not limited to:
    - Clear market regulations; impartial and effective supervision,
    - Fair and efficient trading systems, settlement of trades, competitive and appropriate intermediaries and custodians
    - Full access to all investment products; freely and continuously traded currency
    - Quality of corporate information and timing of disclosure.

Re-classification of countries

Level of political risk and other global considerations

- The existence of political risk has the potential to jeopardize the sustainability of economic development and reforms in a country. It is therefore an important consideration in the assessment of a country's status. The analysis of political risk is subject to analytical judgment in which investor perception of risk will be an important consideration.
- Political risk can be internal, resulting from unstable governments or political coalitions, or from the weakness of institutions protecting people's rights. External risk is due to the presence or risk of regional conflicts.
- Because a re-classification has to be irreversible, the persistence of important risks and lack of stability would disqualify a country from immediate re-classification.
- Other global considerations include the overall assessment of sustainability with respect to a country's level of integration within a regional economic/political block.

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