

Liberalisation, Reclassification & Opening Up: New Life for GCC Markets?

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The stock exchanges of the GCC are comparatively young institutions, mostly established in the mid-1980s. They have been largely closed to international investors, despite the fact that Saudi and the UAE are the largest economies of the Arab world and despite their attractiveness from an international portfolio perspective of diversifying risk and return. Though the GCC economies had grown and diversified their production structures, their markets lacked the liquidity, sufficient size (i.e. depth) and market accessibility. As a result the GCC have been classified as “frontier”, risky markets. But the landscape is rapidly changing with growing international economic and financial integration of the GCC.

The UAE and Qatar financial markets graduated in June 2014 from frontier to emerging market status, as accredited by index compiler MSCI. The reclassification decision had been three years in the offing before the announcement was made on June 12, 2013. Qatar will have a 0.47% weight in the MSCI Emerging Market Index, while UAE will have 0.58%, adding up to just over 1% of the emerging markets total. MSCI has admitted the largest 10 Qatari companies and 9 UAE companies to the All-World index and to the Emerging Markets Index. Qatar National Bank SAQ, Industries Qatar QSC and National Bank of Abu Dhabi PJSC will be the biggest additions.

Does Reclassification Matter?

Institutional investors are restricted by their mandates to investing in developed and emerging markets. Reclassification enables the entry of a new class of investors into the domestic market. The expected benefit of reclassification will result from an anticipated increase in portfolio inflows with the entry of foreign institutional investors and passive or index-tracking investors that will have to rebalance their portfolios to include Qatar and the UAE. Various estimates suggest that the reclassification is likely to attract some USD 300 million to an overly-optimistic USD 4 billion in foreign inflows to the two markets, increasing liquidity and deepening the markets. More buoyant and liquid exchanges and increased exposure to international investment would also encourage local companies to go for initial public offerings (IPOs), thus potentially leading to a much-needed deepening of the equity market in the region.

Market reclassification is important because it acts as a signal to investors that economic policymakers are open to reform and to maintaining their new status as an emerging market. Qatar & the UAE are committing to maintain orderly market conditions and market accessibility, which include openness and protection of foreign investors, unfettered capital flows, an efficient trading and operational framework, sufficiently large size listed companies and liquidity. Importantly, there is also a time-consistency commitment to safeguard the stability of the institutional framework governing the markets, including laws and regulations.

Dangers of Bubbles & Overshooting

In a research report we examined the effect of reclassifications on financial markets. The empirical evidence based on 13 market reclassifications (including upgrades and downgrades) since 1980 suggest that the date of announcement of a market upgrade does have a positive effect on market returns, but the evidence also suggests a negative effect on markets with stock prices *falling* following the formal event

of reclassification. This appears to be confirmed over the past months. UAE and Qatar stock exchanges had performed spectacularly through May 2014, the date of reclassification. However, June and July 2014 experienced dismal returns with spectacular price declines, resulting, in part, from deteriorating regional geopolitical conditions and idiosyncratic effects, such as the Arabtec stock fiasco.

While the asset price decline may seem paradoxical, such a result is consistent with the initial reclassification announcement leading to a bubbling and “overshooting” of prices. This results from investors speculatively bidding up securities prices in advance of the formal reclassification event on the expectation that foreign investors will be entering the market. The overshooting of prices results in asset prices falling following the actual reclassification event. Exuberance and market hype accompanying market reclassification can lead to asset price bubbles. It is likely that these factors drove equity prices upward over the past year in excess of what would be justified by market fundamentals.

Reform Agenda

Reclassification is not a panacea for market ills or corporate mal-governance and lack of transparency & disclosure as exemplified by Arabtec. Typically, reclassifications (both upgrades and downgrades) have followed or been accompanied by economic and financial sector reforms, including improvements in market infrastructure. Both Qatar and the UAE have undertaken technical market infrastructure reforms to upgrade into emerging market status: the former by raising the limits on foreign ownership of companies and the latter by improving the securities settlement system. In August 2014, Qatar issued a law allowing foreign ownership up to 49% of listed companies, a key to attracting foreign investors. But much remains on the reform agenda.

Financial market reclassification is an example of a more general phenomenon: undertaking domestic policy reforms in order to comply with international codes, principles and standards that cover banking, financial, trade, investment, agriculture, industry and a wide swathe of economic activities. Similarly, complying with the obligations of participating in international organisations such as the IMF, the WTO, and WIPO, the BIS, the OECD and similar bodies imposes limits on sovereignty and economic policies and practices. Compliance with international codes & standards is a means, a tool that policy-makers can use for overcoming domestic barriers and opposition to reforms and modernization of laws and institutions. The benefits are increased economic integration, growth of trade and investment and greater factor mobility. External obligations and commitments are also a means of imposing policy discipline against domestic, insular, self-interested groups and politics aiming to serve partisan and protectionist interests.

Foreign Investors

Governments in the GCC, including reclassified Qatar and the UAE, have to liberalise access to their markets by removing barriers to ownership by foreign investors. Currently, the maximum amount of shares available to foreign investors is 49%. The UAE cannot claim to be a global hub while imposing barriers to entry and access to markets. Opening the market to foreign investors is a key reform that needs to be implemented in the near term, while liquidity is another major concern of investors. More regional companies would need to list to provide greater diversification potential and raise trading volumes, which in turn would also attract portfolio investors. Currently, the top weighted stocks in the UAE and Qatar are financial institutions, followed by real estate companies. These do not provide sufficient exposure to the underlying economies and their prospects.

Corporate Governance

The reclassification is likely to raise the bar in terms of corporate governance in Qatar and the UAE. Foreign institutional investors will not be as complacent or inactive as domestic retail investors. Corporate governance rules need stronger enforcement and the timeliness and content of management and financial reporting needs a major overhaul. Reclassification is an opportunity for listed companies to improve their corporate governance and investor relations in accordance with international standards, improve disclosure and transparency and comply with International Financial Reporting Standards.

Build an institutional investor base. Sound, well-functioning financial markets require a broad base of institutional investors to anchor markets. While reclassification attracts foreign investors, they are not a substitute for domestic institutional investors such as investment and pension funds and insurance companies, which typically operate as the backbone of a market. Both the UAE and Qatar will need to develop a legal and regulatory framework to build domestic pension systems as well as liberalise their over-protected, under-developed insurance sectors.

Consolidate Stock Markets. The regional integration of stock exchanges is imperative to developing a liquid market, with a common trading system and a single system for clearance and settlement and security depository. The GCC have small, fragmented markets and their total size is smaller than Hong Kong. The first step in this direction would be the unduly delayed consolidation of the three UAE exchanges to form a common market. The strategic objective for the UAE, (the Arab world's second biggest economy after Saudi) is to have a deep, broad and liquid financial market, building the capacity of managing and controlling their own wealth and being able to allocate capital internationally from their home base thereby gaining international financial power.

Privatise & Demutualise Stock Exchanges

Unlike the majority of the world's stock exchanges, Arab exchanges are mainly owned by governments or are public institutions. The exception is the privately held Palestine Exchange and Nasdaq Dubai which has mixed ownership. Government ownership and related governance and management of the exchanges has been associated with a lack of technological and product innovation, a near-absence of IPOs, substantial volatility and lack of global competitiveness. Large Arab companies list in London or New York and not on their domestic exchanges. Well-designed privatisation and demutualisation of GCC/Arab exchanges would attract capital and investors into the exchanges, provide incentives to invest in electronic trading systems, enable strategic partnerships with international exchanges, lead to changes in governance & management, lower the cost of listing & transactions and change listing rules encouraging the private sector to IPO.

Market reclassification signals economic liberalisation. Properly managed, the Qatar and UAE market reclassification is likely to encourage policy-makers to further liberalize access to their markets by raising foreign ownership limits for investors and adopting investor-friendly legislation & regulation for FDI and not merely portfolio investment. They should not miss the opportunity to open up and develop their capital markets. Efficient, well-functioning markets typically leads to increased private-sector participation in capital markets and would encourage local family businesses to turn into public shareholding companies. Other GCC countries will also emulate and follow the liberalisation path of Qatar and the UAE. Saudi Arabia's July 2014 Cabinet decision to open the Saudi stock market to foreign investors (in addition to GCC nationals) is a momentous decision, assuming that the to-be-issued Capital Market Authority guidelines are not overly restrictive. The opening is likely to happen by the first half of 2015 and would be accompanied by a reclassification of the Saudi market to emerging market status by MSCI. Along with the decision to switch the Saudi weekend from Thursday/ Friday to

Friday/Saturday, allowing market access is the beginning of a long-process of economic liberalisation in Saudi and the GCC. For investors and international trade partners the opening-up of GCC financial markets is likely to herald a greater ouverture, openness and liberalisation of the GCC economies.