Financial markets reform sweeps through MENA
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The collapse in oil prices between 2014 and 2016 is having a long-term impact on MENA (Middle East, North Africa) economies, as the region’s senior policymakers increasingly recognise it is not prudent from a budgetary perspective to be so heavily dependent on such a narrow range of commodity assets.

What followed after the oil price slump was a sharp decline in GDP (gross domestic product) growth, prompting widespread calls for greater economic diversification and market liberalisation, especially in the GCC (Gulf Co-operation Council) countries. Even though GDP growth in some jurisdictions (see table) has resumed, the momentum driving the market reform efforts appears irrevocable.

<table>
<thead>
<tr>
<th>Country</th>
<th>Growth forecast for 2019</th>
<th>Growth forecast for 2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>2%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Kuwait</td>
<td>1.6%</td>
<td>3%</td>
</tr>
<tr>
<td>Oman</td>
<td>1.2%</td>
<td>6% (this one-off spike is attributed to a planned, significant increase in government investment)</td>
</tr>
<tr>
<td>Qatar</td>
<td>3%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>1.7%</td>
<td>3%</td>
</tr>
<tr>
<td>United Arab Emirates (UAE)</td>
<td>2.6%</td>
<td>3%</td>
</tr>
</tbody>
</table>

Furthermore, IPO (initial public offering) activity in MENA has increased exponentially. There were six listings in Q2 of 2019 raising $2.8 billion,² a 222.6% year-on-year increase³ with the bulk of this activity taking place in Saudi Arabia, where local IPOs raised over $1 billion.⁴ Moving forward, IPO volumes are expected to increase throughout the region as governments in Saudi Arabia, Qatar, Oman and Egypt accelerate various privatisation initiatives.⁵ Most notably, there are proposals in the pipeline to list 50% of Boursa Kuwait’s shares,⁶ while there is speculation in Saudi Arabia that ARAMCO’s IPO could be resurrected.⁷

¹ World Bank (May 1, 2019) Gulf Economic Monitor, April 2019: Building the foundations for economic sustainability: Human capital and growth in the GCC
² EY (Q2 2019) MENA IPO Eye
³ The National (August 6, 2019) Value of MENA stock market listings treble in second quarter
⁴ EY (Q2 2019) MENA IPO Eye
⁵ EY (Q2 2019) MENA IPO Eye
⁶ The Banker (April 4, 2019) FTSE Emerging market listing shows Kuwait means business
⁷ The Economist (July 6, 2019) The world’s biggest potential IPO may be on again
Opening up the markets further to global investors

Whereas the UAE and Qatar opened up their markets to foreign investors almost a decade ago, other major regional economies – principally Saudi Arabia – have only now just started to follow suit. Saudi Arabia and Kuwait have been diligently implementing a series of expansive market reforms, a strategy they hope will leave a legacy of foreign institutional investment, facilitated by index inclusion, thereby eliminating their decades-long dependency on commodities. According to HSBC data, past MSCI inclusions in the GCC – principally in the UAE and Qatar, both upgraded back in 2014 - sparked a flood of investment activity.

Prior to 2015 when reforms in Saudi Arabia were first announced, global investors could only obtain very limited access to the country’s listed equities through customised swap instruments, meaning foreign holdings accounted for just $9 billion or 1.6% of the overall market.8 This was despite Saudi Arabia’s domestic stock exchange - the Tadawul - being far larger and much more liquid than any of its nearest regional rivals.

Since 2015, constraints on foreign ownership of domestic Saudi Arabian companies have been relaxed, as have the once rigid entry requirements for global investors. Today, QFI (qualified foreign investor) licenses are granted to regulated banks, brokerages, fund managers, insurance companies or securities firms with at least $500 million in assets. In addition, the Capital Market Authority (CMA), the local regulator, announced in 2018 that QFIs will no longer need to have minimum investment experience prior to authorisation.

Ease of access is pivotal

While opening up securities markets is a positive development, it is also crucial that the investor approval process is as frictionless as possible. The authorities in MENA are certainly looking to enable this. For example, the CMA in Saudi Arabia – who was initially entrusted with authorising QFI applications – has since delegated the approval process to custodians (also known as Assessing Authorised Persons [AAPs]). This has helped expedite the entire authorisation procedure for investors, making it easier to access the local securities market.

Similar changes are underway elsewhere. Previously in Kuwait, account opening requests submitted to the Kuwait Clearing Company (KCC) required sign-off from the Kuwait Stock Exchange (KSE). However, Boursa Kuwait, which now runs the exchange, has since scrapped the formal approval process allowing for more efficient account openings. Likewise, Investor Number (NIN) documentation requirements have been simplified across the UAE, Kuwait and Egypt too, making it easier for institutional investors to access the markets in MENA more widely.

Minimising operational risk

A number of foreign fund managers – especially those regulated under the EU’s AIFMD (Alternative Investment Fund Managers Directive) and UCITS (Undertakings for the Collective Investment in Transferable Securities) – have long been averse to accumulating portfolio holdings in markets with insufficient investor protections. Similarly, US mutual funds authorised under the 1940 Investment Act have also been precluded from acquiring assets in certain markets, namely countries where there is not a functioning custody model (i.e. where local, poorly capitalised or risky brokers may act as custodians).

8 Financial Times (June 14, 2015) Saudi Arabia opens up its $560 billion stock market to foreign investors
However, MENA markets have implemented a number of structural changes over the last few years to satisfy the regulatory requirements of AIFMs, UCITS and 40 Act fund managers.

In order to attract wider foreign investment, Saudi Arabia’s CMA developed its own independent custody model, rolled out DVP (delivery versus payment) and moved away from the T+0 settlement cycle to T+2, which eliminated the need for institutions to pre-fund all of their transactions. The shift towards T+2 in Saudi Arabia has been credited with reducing counterparty risk for investors trading in the local market. Kuwait has also phased in a series of ambitious post-trade reforms - as part of its Market Development Project (MD) - enhancing investor protections. These initiatives include the adoption of a harmonised (T+3) trade settlement cycle; the introduction of a DVP mechanism; the establishment of a custodian rejection facility; and the enactment of best practices around corporate actions.9

Kuwait has also been quick to adopt other market best practices. Kuwait’s MD3 programme contains provisions which will split the KCC into two distinct legal entities, both of which will have separate licenses to operate as a Central Counterparty Clearing House (CCP) and Central Securities Depository (CSD). These regulatory transformations will play an integral role in drawing more foreign institutional flows into the MENA region.

Efficiencies are also being realised through automation, which is being adopted at a number of CSDs, evidenced by the plan to digitize proxy voting in Qatar and proposed E-voting procedures in the UAE. A minority of CSDs, including the Abu Dhabi Securities Exchange (ADX), are even looking to leverage distributed ledger technology (DLT) in coalition with SWIFT to streamline corporate actions and proxy voting processes.10 Again, robust and fully automated infrastructures will be critical if foreign institutional investor inflows are to be realised.

**Strengthening governance**

Among some of the key criterion for investing in any given market is that client assets are recoverable in a crisis event and treated fairly during a default. In response, a handful of MENA markets have updated their insolvency codes, bringing them into line with globally accepted best practices. Bahrain has introduced bankruptcy laws mirroring the Chapter 11 process in the US, which outlines measures allowing a defaulting company to reorganise itself with management in place.11 Kuwait is also introducing material enhancements to its insolvency rules 12, conscious that the existing process is heavily disjointed as there is no singular, overarching piece of legislation bestowing bankruptcy protection to investors.

Equally critical is corporate governance reform, which is an area a number of MENA markets are working on. For instance, Saudi Arabia’s CMA has prioritised corporate governance as it looks to strengthen the rights of shareholders and board members.13 The CMA is also insisting companies provide greater disclosure about their commercial strategic planning, roles and responsibilities, and oversight of corporate entities and third parties.14 Increasingly, progressive local companies are beginning to publish financial statements and audit reports bilingually (English/Arabic), which has been applauded by foreign investors.

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9 Investment Week (June 26, 2019) MSCI Kuwait Index to be reclassified to EM status by the end of 2019
10 SWIFT (January 16, 2018) SWIFT and CSD community advance blockchain for post-trade
11 Arab News (October 4, 2018) Bahrain introduces bankruptcy law in legal reform push
12 Arabian News (1 May 2017) Kuwait set to ratify insolvency law
13 CMA (March 28, 2018) Saudi Stock Exchange joins FTSE Global Equity Index Series
14 CMA (March 28, 2018) Saudi Stock Exchange joins FTSE Global Equity Index Series
Creating world-class infrastructure

A handful of countries have set in motion plans to create CCPs (central counterparty clearing houses). CCPs are pivotal for facilitating risk management, although some experts do hold reservations about establishing them in markets where daily derivative trading volumes are fairly meagre. However, during discussions with HSBC the UAE’s Securities and Commodities Authority (SCA), the domestic regulator and Saudi Arabia’s CMA are reportedly planning to launch CCPs in their markets by the end of 2020, while the Kuwaiti authorities have confirmed a cash CCP will be unveiled in due course.

Deepening the product pool

As MENA economies look to deepen their liquidity, local regulators are busy rolling out new investment products and trading instruments. Through its MD3 initiative, Kuwait’s CMA has said it will create a regulatory framework to support short-selling, along with securities lending and securities borrowing.\(^5\) Meanwhile, the Tadawul in Saudi Arabia launched the MSCI Tadawul 30 Index in January 2019, a tradable index comprised of the 30 largest listed securities on the domestic exchange.\(^6\) The Tadawul also confirmed that it plans to launch derivatives products, including exchange traded index futures contracts, later this year.\(^7\)

Inclusion of Saudi Arabia and Kuwait

Having implemented a series of dynamic and positive market reforms, MSCI notified that Saudi Arabia was to be included to its Emerging Markets Index in June 2019, with a weighting totalling 2.6% of the benchmark.\(^8\) Experts have predicted that MSCI inclusion could result in up to $40 billion\(^9\) of active and passive fund capital flowing into Saudi Arabia. However, $10.8 billion had already entered the country in 2019 even prior to inclusion occurring, inflows which are comparable to that of China and India.\(^10\) In addition to MSCI, FTSE Russell confirmed Saudi Arabia would be incorporated onto its Emerging Markets index over a course of five tranches between March 2019 and March 2020,\(^11\) giving it a 0.27% weighting, potentially facilitating approximately $5 billion of passive and active flows. Earlier this year, Saudi Arabia was also inducted onto S&P Dow Jones’ Emerging Market Indices.\(^12\)

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1\(^5\) CMA (November 28, 2018) Announcement on the timeline for the third phase of the Market Development Project
2\(^5\) Tadawul (January 30, 2019) MSCI and Tadawul tradable index goes live
3\(^5\) Tadawul (January 30, 2019) MSCI and Tadawul tradable index goes live
4\(^8\) MSCI (June 20, 2018) Results of MSCI 2018 Market Classification Review
5\(^9\) Reuters (May 29, 2019) Global woes weigh on Saudi stocks as they join MSCI index
6\(^9\) The National (June 23, 2019) Saudi Tadawul gets $10.8bn so far in 2019 on MSCI upgrade
7\(^9\) Tadawul (March 18, 2019) Saudi Arabia inclusion to FTSE Russell and S&P Dow Jones into emerging market indices
8\(^9\) Tadawul (March 18, 2019) Saudi Arabia inclusion to FTSE Russell and S&P Dow Jones into emerging market indices
Reforms in Kuwait have helped fortify its standing, and convinced FTSE Russell to add the country to its Emerging Markets Index, a milestone that could result in between $500 million and $800 million of foreign investment moving into the local equity market. In June 2019, MSCI indicated that Kuwait will be integrated onto its Emerging Markets Index too, on condition that omnibus account structures and NIN cross-trading are made available to foreign investors by November 2019. At present, only locally licensed firms are permitted to trade using omnibus accounts, “and same NIN trading is only available to certain exempt non-discretionary local accounts.” MSCI has said a final decision on Kuwait’s status will be made by December 31, 2019. Should inclusion go ahead, nine Kuwaiti stocks are likely to be added to MSCI’s benchmark with a pro-forma index weighting of approximately 0.5%, in what could result in circa $2.8 billion of passive flows moving into the country.

Keeping up momentum

The MENA region is at the forefront of reforms, which could lead to significantly improved liquidity across a number of these markets, as foreign institutional investors step up their search for returns. It is also likely to prompt a flurry of listing activity within MENA as privately owned businesses look to capitalise on the growing investor interest in their markets. As a result of these market reforms and index inclusions, the MENA region is fast becoming an area of greater interest for institutional investors.

However, MENA markets that have either been reclassified or are undergoing assessment, need to continue pursuing their harmonisation and reform programmes. Reclassification should not be seen as an end result, but rather the beginning of a journey. As MENA economies endeavour to improve their markets, they will be recompensed with increased index weightings, which in turn will encourage greater active and passive flows, and ultimately deeper liquidity.

HSBC has a deep, rich history in MENA. Consequently, HSBC is widely seen as an industry-leading authority on securities trading and post-trade in the region, working with a wide range of local and global market participants and intermediary providers, putting it in a strong position to advocate international standards and harmonisation. HSBC is committed to partnering with its clients to create solutions that meet both local and global demands.

23 The Banker (April 4, 2019) FTSE Emerging market listing shows Kuwait means business
24 MSCI (June 25, 2019) Results of the MSCI 2019 Market Classification Review
25 MSCI (June 25, 2019) Results of the MSCI 2019 Market Classification Review
26 MSCI (June 25, 2019) Results of the MSCI 2019 Market Classification Review
27 MSCI (June 25, 2019) Results of the MSCI 2019 Market Classification Review
28 Financial Times (June 26, 2019) MSCI upgrades Kuwait to emerging market status
29 The Banker (April 4, 2019) FTSE Emerging market listing shows Kuwait means business