Headline: Why MSCI's index call is bad	
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Why MSCI's index call is bad

The threat to reduce India's weight after the exchanges decided to cut off market data needs to be called for the bluff that it is

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The three Indian stock exchanges, the BSE, NSE and the MSEI, stirred a hornet's nest last week when they decided to stop providing market data to enable trading on foreign exchanges and platforms. While the reaction of many global institutions was conciliatory, MSCI Inc, the global index provider, made the strongest comment against the move.

The Washington-based Futures Industry Association (FIA) stated mildly that it looks forward to discussing this issue with the Indian exchanges and working with its members to better understand the consequences for derivative markets.

The Singapore Stock Exchange (SGX) that stands to lose a part of its revenue through this move, also took a placatory stance. It announced that it will list successor products to its Nifty family of derivative products, before the licence from Nifty expires in August 2018 to ensure that investors can continue trading without any disruption. SGX has also stated that it will consider developing solutions from NSE's International Exchange in the Gujarat International Finance Tech (GIFT) city's International Financial Services Centre.

However, the most scathing attack so far came from the global index provider, MSCI. It said in its statement that the breadth of the restrictions announced is "unprecedented" in any equity market in the MSCI Emerging Markets Index series. It went on to suggest that the Indian exchanges and their regulator should reconsider this action.

But what is a little jarring is the subtle threat issued by MSCI stating that the introduction of these restrictive measures could lead to a change in India's market classification in its indices. In other words, MSCI is saying that India's weight in MSCI's indices could be reduced, thus impacting portfolio flows into India.

This reaction appears a little over the top considering the manner in which FPIs are free to transact on Indian bourses. A close look shows that the "competitive landscape clause" that MSCI is currently waving at India, does more to protect the index provider's interest than acting in the larger interest of global markets.

The decision

It is widely known that trading in Nifty, rupee and some stock futures have been shifting to the SGX and the Dubai Gold and Commodity Exchange (DGCX) over the last decade. The SGX currently accounts for more than half the trades in Nifty futures and almost one-fourth of future trades in dollar rupee futures while DGCX accounts for one-third of rupee future volume.

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In a bid to stop this migration of volume from domestic bourses the three Indian exchanges jointly decided to stop providing data feed on stock prices and indexes to foreign exchanges or trading platforms for trading or settling derivatives, once the ongoing licences with various exchanges expire. Without the right to use the underlying prices, trading of derivatives on overseas platforms would have to stop.

While this would have impacted exchanges where Indian indices and stock futures or options are currently being traded, MSCI's ire would have been mainly due to the decision by the exchanges to stop providing market data to index providers for the creation of indexes or other products based on such indices that would be made available for trading or settling derivatives on foreign exchanges or trading platforms.

Let the data flow Flying in the face of new developments RAWPIXEL/ISTOCKPHOTO

MSCI index futures

Many MSCI indices are licensed to foreign exchanges to allow them to launch derivative products based on these. While the restriction will apply to only those MSCI indices where India's weight is over 25 per cent, there are many India-specific MSCI indices such as the MSCI India index with futures that are listed on many global exchanges. With the recent restriction, MSCI will have to stop licensing data on India-specific indices to global exchanges.

India's weight in larger MSCI indices such as the MSCI emerging market index, that has around $1.6 trillion of assets tied to it, is however only around 8 per cent. This index will not be impacted by the recent move. Similarly, India's weight in MSCI Asian Pacific Index is also quite low. The index provider, MSCI, can continue to allow futures to be traded based on these larger indices.

Competitive landscape clause

MSCI has already protected its back against such restrictive moves by other global exchanges through the "competitive landscape clause" in its market classification framework. This framework is set out to determine the classification of a market in either of the three primary buckets — frontier, emerging and developed. One of the criteria used to determine the classification is market accessibility that includes openness to foreign ownership, ease of capital flows, efficiency of operational framework, competitive landscape and stability of institutional framework.

While the Indian market scores well on most of the benchmarks used to evaluate market accessibility, the index provider is now saying that the recent move will make India fall short in the competitive landscape clause.

The market classification framework defines the competitive landscape clause as "existence of anti-competitive clauses restricting investors' access to derived stock exchange information... In addition, anti-competitive clauses should not result in global or regional financial products becoming in breach of local market rules, regulations or other restrictions".

Arm-twisting by another name

MSCI has said it will begin consultation with institutional investors to see if they would be impacted by the bourses' move and then move to re-classify India in its indices. But it is clear that MSCI's concern could also stem from the impact the move may have on the India-specific index futures the company has licensed to global exchanges.

The moot question is whether accessibility will really be restricted. Foreign investors who are willing to register with SEBI and purchase Indian stocks for their portfolio are quite likely to hedge their risk on the domestic derivative markets. A chunk of domestic derivative volumes are anyway through FII trades.

Foreign investors who do not wish to be exposed to currency risk can trade on the Indian indices and stock futures on the GIFT IFSC. Both transaction cost and taxes are quite low there. It's time to look past the glaze of 'anti-competitiveness' rhetoric, to see where MSCI Inc is coming from.