AN INCLUSIVE APPROACH TO INCLUDING CHINA A-SHARES

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The highly anticipated announcement on 9 June on the potential inclusion of China A-shares into the MSCI China index and corresponding composite indexes – in particular the MSCI Emerging Markets index (MSCI EM), which Reuters says "is tracked by USD 1.7 trillion of funds" – turned out to be a non-event. But was it?

Index providers, such as MSCI Inc. and FTSE Group, with certain mutual fund companies in their wake, had in recent months warmed to the idea of including the onshore A-shares in their index and portfolio compositions.

When MSCI reviews its market classification framework with a view to possibly adjust its indices, it does so according to a strict script and in consultation with international institutional investors. Any adjustments or non-adjustments to its markets review list are usually announced annually and, in the case of a decision on changes, these are implemented after at least 12 months.

After a second round of consultations on the topic, MSCI in this year's announcement lauded the "significant positive market-opening developments in the Chinese capital market" over the past year and expected further progress on greater market accessibility. But the index provider held back from endorsing an initial A-shares inclusion into its indices.

However, in an inclusive approach, the MSCI announced the establishment of a working group with the China Securities Regulatory Commission (CSRC) to tackle lingering concerns by international institutional investors. According to a statement by the index provider "the quota allocation process, capital mobility restrictions and beneficial ownership of investments" will be major focus areas.

Addressing these concerns would in effect speed up the process towards future inclusion. MSCI went one step further in announcing that the inclusion of A-shares could occur outside of the usual annual review timeline. The proposal to implement a 5% inclusion of A-shares in 2017 – a first phase in a gradual process – remains in place. To put things into perspective, a 5% inclusion would represent a still modest 1.3% of the MSCI Emerging Markets index total weight, based on current numbers (whereas the addition of overseas-listed China companies to the MSCI EM later this year should increase the proportion of Chinese shares overall in the MSCI EM from 25.3% to 30%).

As barriers to market access gradually dissolve, more money flow into China. There will likely be further pressure to add A-shares to MSCI-benchmarked portfolios with exposure to China.

The inclusion of A-shares in the MSCI indices looks to be an exercise in expectations management, communication and moving in tune. Full inclusion should be a big win for all parties. Through greater exposure, international institutional investor portfolios should better reflect China's weight in the world economy, while China could benefit from tremendous inflows of international institutional money. This should render the onshore equity market less volatile and more transparent and raise the status of the renminbi internationally.

The path to this shared destination is important, in our view. An inclusive approach that fosters dialogue between stakeholders is a positive and healthy, yet potentially lengthy process in which the alignment of stakeholder interest is crucial.

Sources: "UPDATE 1-MSCI faces opposition to China inclusion in key index -sources", Reuters, 13 March 2015; "MSCI market classification review, discussion on the review results", MSCI, 16 June 2015.

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