Research

FTSE Country Classification Process

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Introduction

This paper describes the FTSE country classification process which is designed to be transparent and evidence-driven. External advisory committees ensure that the criteria used to determine country classification meet the needs of global investors and are judged objectively. Consistent with the Principles for Financial Benchmarks published by IOSCO in 2013, the operation of the country classification process is overseen by FTSE Russell's strong internal governance structure.

By classifying countries according to objective criteria, and engaging with stock exchanges, regulators and central banks in those countries where the market is being considered for potential promotion or demotion, the process provides portfolio managers and asset allocators with a clear view of expected future index evolution.

History

The FTSE Global Equity Index Series (GEIS) had its genesis in 1985 with the creation of the FT-Actuaries World Index. As the name suggests, the index was a collaborative venture between the Financial Times and the Institute and Faculty of Actuaries; the other founding partners were the investment bank Goldman Sachs and broker Wood Mackenzie and Co. At inception the index covered 27 countries and there was no distinction between developed and emerging markets.

In 1995, Wood Mackenzie sold its stake to Standard and Poor's, giving rise to the FT/S&P Actuaries World Index, and in 1997 when FTSE took over the calculation the index was renamed as the FTSE/S&P- Actuaries World index. FTSE, which had been formed as a joint venture between the London Stock Exchange and the Financial Times in 1995, bought out the other partners in 1999 and the index was renamed as the FTSE World Index.

Country and capitalization coverage were expanded further with the incorporation of the Barings Emerging Market Index in 2000. This added 20 countries and extended coverage to 90% of global equity markets. At the time of this expansion, the opportunity was taken to classify the countries in the existing World Index into "Developed" and "Advanced Emerging" markets. The additional countries from the Barings index were classified as "Emerging" markets and their combination with the World Index was termed the All-World Index. A fourth grouping, "Frontier" markets, was introduced in 2008 to capture those markets not yet sufficiently evolved to be categorized as Emerging. As of March 2017, the FTSE All-World index includes 47 countries with a further 27 countries classified as Frontier markets.

Classification Schemes

Early distinctions between developed and emerging markets were somewhat arbitrary and tended to focus on the relative wealth of countries as the distinguishing measure together with subjective judgements about the quality of the market. This lack of transparency made it hard for investors to gauge the likelihood of countries moving between categories, and did not foster the spirit of engagement that would encourage countries to adopt global best practice in pursuit of promotion. The expansion of the GEIS prompted FTSE to launch a client consultation in 2003 which proposed a structured framework for classifying markets that would be consistent with FTSE's philosophy of rules-based, objective indexes. As well as consideration of country per capita income, the proposal set out other guiding principles for market classification. These were:

- Quality of Market – the quality of regulation, the dealing landscape, custody and settlement procedures, and the presence of a derivatives market would all be taken into account;

- Materiality – a country needed to be of material size to warrant inclusion in a global benchmark;
- Consistency and Predictability – a pathway to classification changes would be set out by announcing a "Watch List" of countries that were being considered for promotion and demotion as well as the criteria by which countries would be judged;
- Cost Limitation – the cost of implementing a change would be taken into account when assessing a market for promotion or demotion;
- Stability – a phased approach would be taken to the introduction of new countries; a new country would only join as an emerging market; and promotion would only occur in response to permanent changes in market status and global acceptance; and
- Market Access – international investors should be able to invest and withdraw funds in a timely and secure manner at reasonable cost.

The results of the consultation were published in November 2003. These showed very strong support for the inclusion of Quality of Markets criteria along the lines summarized above. The majority of respondents were also in favor of the other principles. On the basis of the support received, FTSE moved ahead with implementing this country classification scheme in 2004.

The FTSE Country Classification Process

Following the 2003 client consultation, FTSE put in place a formal process for assessing markets. This process had the following elements:

- A Quality of Markets matrix against which markets could be objectively judged and compared.
- A questionnaire with which to engage stock exchanges and regulatory authorities, the responses to which would help form the basis of the initial Quality of Markets assessment and subsequent upgrades.
- A new FTSE Russell Country Classification Advisory Committee reporting to the FTSE Russell Policy Advisory Board that would undertake objective assessments of markets against the Quality of Markets criteria.
- A Watch List consisting of those countries that are judged to meet, or to be close to meeting, the Quality of Markets criteria for promotion or demotion that would act as a staging post for subsequent country classification changes.
- A policy of engagement with markets that were placed on the Watch List to help them understand what steps would need to be taken to improve their current assessments to make them eligible for promotion (or to prevent their demotion).
- An annual schedule for determining country classification and Watch List changes culminating in country classification and Watch List changes being announced in September.
- A defined communication and implementation timetable to allow portfolio managers to make the necessary preparations for changes to classifications.

Further details regarding these elements are provided below.

Quality of Markets Matrix

The Quality of Markets Matrix is central to the above process. An example of the Quality of Markets matrix for the Emerging Europe region is provided in Appendix 1. For example, the Czech Republic, Greece, Hungary and Turkey are currently classified as Advanced Emerging markets, and Russia as a Secondary Emerging market. The matrix also includes information on the Gross National Product per capita as calculated by the World Bank; this was one of the original mechanisms used to help distinguish between the different classifications. The country's credit rating is a more recent addition to the criteria.

The rest of the matrix is divided into four sections: Dealing Landscape and Brokers, Custody and Settlement, Regulation, and Derivatives. Each section is further broken down into those factors that are considered essential ingredients for each classification. Markets are scored as "Pass", "Restricted" (partial failure) or "Not Met" on each of these factors. Developed markets should not fail on any category, although a very small number of Restricted scores may be accepted. Advanced Emerging markets have to pass fewer categories, and Secondary Emerging and Frontier markets fewer still. Appendix 2 shows the relevant categories for each classification.

Questionnaire

In the case of countries that have not previously been evaluated, or countries where a re-assessment is considered timely, a questionnaire is sent to country contacts, usually at the stock exchange, inviting responses on the criteria covered by the Quality of Markets matrix. The questionnaire breaks each criterion into its essential details and requests information on these aspects so as to facilitate a reasoned determination of the country's score.

The FTSE Russell Country Classification Advisory Committee

The FTSE Russell Country Classification Advisory Committee is formed of market practitioners with technical expertise in trading, portfolio management, and custody who are able to provide first hand experience of each of these areas. Each country's scores on the Quality of Markets matrix are kept under review and proposals for changes to scores are debated at the meetings of the FTSE Russell Country Classification Advisory Committee. Any changes to the scores recommended by the Committee are duly minuted and changes to country scores are formally communicated by FTSE Russell to the relevant authorities each year in March and September.

The FTSE Russell Country Classification Advisory Committee also reviews the responses received to the engagement questionnaire. In many cases the Committee will ask for further research to be undertaken, or will themselves check with colleagues as to whether a response is confirmed by their practical experience of market conditions, before finally deciding on a country's scores on the Quality of Markets criteria.

The FTSE Russell Policy Advisory Board

The FTSE Russell Policy Advisory Board is the most senior of FTSE Russell's external advisory committees and draws its membership from senior personnel at investment management companies, investment consultants and asset owners. For the country classification process, the FTSE Russell Policy Advisory Board provides the important role of ensuring in the final analysis that proposals for classification changes initiated by reference to the requisite number of criteria being judged to exceed the requirements for country promotion, or failing to meet the requirements to prevent country demotion, are consistent with the perceptions of seasoned investors at that time.

The Watch List

To enable investors to plan for potential classification changes, FTSE Russell operates a Watch List of those countries with scores on the Quality of Markets matrix that have been judged to have met, or are becoming close to meeting, the technical criteria required for reclassification. The Watch List also includes those countries with scores that have been judged to have fallen below those required to maintain the countries' current classifications and are being considered for demotion.

Absent any extraordinary circumstances, a country must stay on the Watch List for at least one year, and may potentially remain there for several years, before it is considered ready for reclassification. This is consistent with the principles set out earlier that countries should only change classification infrequently, when the appropriate standards have been confirmed for a period of time, and that investors should be forewarned of the prospect. A seasoning period on the Watch List thus allows investors to become comfortable that the technical criteria assessed through the Quality of Markets framework are indeed being met in practice.

Engagement

To encourage those markets on the Watch List to adapt their procedures to meet international best practice, FTSE Russell actively engages with the appropriate authorities of those countries that have been added to the Watch List with a view to helping them understand the standards required for their future promotion, or to prevent their future demotion.

Annual Schedule

The FTSE country classification process operates to an annual schedule starting in January and finishing in September. The process starts with in-depth assessments of those markets on the Watch List as agreed in the previous September, and those countries highlighted for possible addition to the Watch List in the next September.

Between January and September, the Quality of Markets scores for current and potential Watch List countries are reviewed by the FTSE Russell Country Classification Advisory Committee. Throughout this period, evidence of improvements or deterioration in a country's scores is actively sought through engagement with the appropriate authorities of the country concerned.

The concluding debate on changes to the Watch List takes place at the September meeting of the FTSE Russell Country Classification Advisory Committee. Also at this meeting, the countries on the Watch List are formally reviewed for promotion or demotion and the Committee's recommendations for country promotions and demotions, if any, are presented to the September meeting of the FTSE Russell Policy Advisory Board. Those promotion and demotion recommendations that are endorsed by the FTSE Russell Policy Advisory Board are forwarded to the FTSE Russell Governance Board in September for final approval.

An announcement of a market reclassification may be made at the March Interim Update, subject to the approval of the FTSE Russell Governance Board, and with the endorsement of the FTSE Russell Country Classification Advisory Committee and the FTSE Russell Policy Advisory Board.

To inform the market of the date of the Annual Announcement a public notice is published on the FTSE Russell website and sent to clients in advance of the announcement date.

Communication

Following the September or the March meeting of the FTSE Russell Governance Board, promotion and demotion decisions and Watch List changes are formally communicated to the countries affected together with the rationale as evidenced by their scores on the Quality of Markets matrix. Promotion, demotion and Watch List decisions are subsequently published in a public notice along with the timetable for their implementation.

Implementation of classification changes is ordinarily timed to coincide with one of the semi-annual reviews for GEIS and a minimum notice period of six months is always provided to allow investors and asset owners adequate time to prepare.

Conclusion

Since its inception in 2003, the FTSE country classification process has matured into a transparent and objective mechanism of classifying markets in a way that is designed to meet the ongoing needs of institutional investors. The existence of a Watch List, enables investors to plan for potential classification changes and implement these at a time of their own choosing if they so wish. The process also encourages those markets on the Watch List to engage with FTSE Russell to adapt their environment to meet international best practice. The result is a forward-looking, proactive framework that managers can trust.

FTSE Russell keeps the criteria used to determine a country's classification under continuous review. FTSE Russell welcomes the views of all stakeholders on the future evolution of its country classification scheme to ensure it continues to exhibit thought leadership and meets their needs. Comments can be sent to committeesecretary@ftserussell.com.

Appendix 1. Example of the Quality of Markets Matrix for the Emerging Europe Region (as at September 2017)

Criteria	DEV Watch	Poland*	ADV EMG	Czech Republic	Greece	Hungary	Turkey	SEC EMG	Russia	SEC EMG Watch	Romania
	Country Names										
World Bank GNI Per Capita Rating, 2015		**High**		**High**	**High**	**High**	**Upper Middle**		**High**		**Upper Middle**
Credit Worthiness		**Investment**		**Investment**	**Highly Speculative**	**Investment**	**Speculative**		**Speculative**		**Investment**
Market and Regulatory Environment											
Formal stock market regulatory authorities actively monitor market (e.g., SEC, FSA, SFC)	X	PASS	X	PASS	PASS	PASS	PASS	X	PASS	X	PASS
Fair and non-prejudicial treatment of minority shareholders	X	PASS	X	PASS	PASS	PASS	PASS		PASS		PASS
No or selective incidence of foreign ownership restrictions	X	PASS	X	PASS	PASS	PASS	PASS		RESTRICTED		PASS
No objection to or significant restrictions or penalties applied to the investment of capital or the repatriation of capital and income	X	PASS	X	PASS	PASS	PASS	PASS	X	PASS	X	PASS
Free and well-developed equity market	X	PASS	X	PASS	PASS	PASS	PASS		RESTRICTED		NOT MET
Free and well-developed foreign exchange market	X	PASS	X	PASS	PASS	PASS	PASS		PASS		RESTRICTED
No or simple registration process for foreign investors	X	PASS	X	PASS	PASS	PASS	PASS		RESTRICTED		RESTRICTED
Custody and Settlement											
Settlement - Rare incidence of failed trades	X	PASS	X	PASS	PASS	PASS	PASS	X	PASS	X	PASS
Custody-Sufficient competition to ensure high quality custodian services	X	PASS	X	PASS	PASS	PASS	PASS	X	PASS		PASS
Clearing & settlement - T + 2 , T + 3	X	T+2	X	T+2	T+2	T+2	T+2	X	T+2	X	T+2
Settlement - Free delivery available	X	PASS		PASS	PASS	PASS	PASS		PASS		RESTRICTED
Custody - Omnibus and segregated account facilities available to international investors	X	PASS	X	PASS	RESTRICTED	PASS	RESTRICTED		PASS		NOT MET
Dealing Landscape											
Brokerage - Sufficient competition to ensure high quality broker services	X	PASS	X	PASS	PASS	PASS	PASS	X	PASS		PASS
Liquidity - Sufficient broad market liquidity to support sizeable global investment	X	PASS	X	PASS	PASS	PASS	PASS	X	PASS		NOT MET
Transaction costs - implicit and explicit costs to be reasonable and competitive	X	PASS	X	PASS	PASS	PASS	PASS	X	PASS		PASS
Stock lending is permitted	X	PASS		RESTRICTED	RESTRICTED	RESTRICTED	PASS		NOT MEET		RESTRICTED
Short sales permitted	X	PASS		RESTRICTED	PASS	PASS	PASS		PASS		RESTRICTED
Off-exchange transactions permitted	X	PASS		PASS	RESTRICTED	PASS	PASS		PASS		NOT MET
Efficient trading mechanism	X	PASS		PASS	PASS	PASS	PASS		PASS		PASS
Transparency - market depth information / visibility and timely trade reporting process	X	PASS	X	PASS	PASS	PASS	PASS	X	PASS	X	PASS
Derivatives											
Developed Derivatives Market	X	PASS		NOT MET	PASS	PASS	RESTRICTED		PASS		RESTRICTED

Shading indicates a change from March 2017

*Poland to be promoted to Developed market status, effective from September 2018.

Appendix 2. Quality of Markets Matrix

Criteria	Developed	Advanced Emerging	Secondary Emerging	Frontier
World Bank GNI Per Capita Rating				
Credit Worthiness				
Market and Regulatory Environment				
Formal stock market regulatory authorities actively monitor market (e.g., SEC, FSA, SFC)	X	X	X	X
Fair and non-prejudicial treatment of minority shareholders	X	X		
No or selective incidence of foreign ownership restrictions	X	X		
No objection to or significant restrictions or penalties applied to the investment of capital or the repatriation of capital and income	X	X	X	X
Free and well-developed equity market	X	X		
Free and well-developed foreign exchange market	X	X		
No or simple registration process for foreign investors	X	X		
Custody and Settlement				
Settlement - Rare incidence of failed trades	X	X	X	X
Custody-Sufficient competition to ensure high quality custodian services	X	X	X	
Clearing & settlement - T+2 / T+3	X	X	X	X
Settlement - Free delivery available	X			
Custody - Omnibus and segregated account facilities available to international investors	X	X		
Dealing Landscape				
Brokerage - Sufficient competition to ensure high quality broker services	X	X	X	
Liquidity - Sufficient broad market liquidity to support sizeable global investment	X	X	X	
Transaction costs - implicit and explicit costs to be reasonable and competitive	X	X	X	
Stock Lending is permitted	X			
Short sales permitted	X			
Off-exchange transactions permitted	X			
Efficient trading mechanism	X			
Transparency - market depth information/visibility and timely trade reporting process	X	X	X	X
Derivatives				
Developed Derivatives Market	X			

Appendix 3. FTSE Country Classifications (as at September 2017)

Developed (25 Markets)	Advanced Emerging (10 Markets)	Secondary Emerging (13 Markets)	Frontier (29 Markets)
Australia	Brazil	Chile	Argentina (4, 10 & 14)
Austria	Czech Republic (7)	China	Bahrain
Belgium/Luxembourg	Greece (1 & 11)	Colombia	Bangladesh
Canada	Hungary (3)	Egypt	Botswana
Denmark	Malaysia (7)	India	Bulgaria
Finland	Mexico	Indonesia	Côte d'Ivoire
France	South Africa	Kuwait (15)	Croatia
Germany	Taiwan	Pakistan	Cyprus
Hong Kong	Thailand (8)	Peru	Estonia
Ireland	Turkey (7)	Philippines	Ghana (9)
Israel (2)		Qatar (12)	Jordan
Italy		Russia	Kazakhstan (14)
Japan		UAE (5)	Kenya
Netherlands			Latvia (13)
New Zealand			Lithuania
Norway			Macedonia
Poland (3 & 15)			Malta (6)
Portugal			Mauritius
Singapore			Morocco (10)
South Korea (4)			Nigeria
Spain			Oman
Sweden			Palestine (13)
Switzerland			Romania
UK			Serbia
USA			Slovakia
			Slovenia
			Sri Lanka
			Tunisia
			Vietnam

Timeline of FTSE Country Classification Changes
(1) 02 Jan 2001 – Greece promoted from Advanced Emerging to Developed 20 June 2003 – Venezuela deleted from All–World Secondary Emerging at zero value
(2) 22 Sept 2008 – Israel promoted from Advanced Emerging to Developed
(3) 22 Sept 2008 – Hungary and Poland promoted from Secondary Emerging to Advanced Emerging
(4) 21 Sept 2009 – South Korea promoted from Advanced Emerging to Developed 20 Sept 2010 – Argentina demoted from Secondary Emerging to Frontier
(5) 20 Sept 2010 – UAE added directly to Secondary Emerging from Unclassified (bypassing Frontier)
(6) 20 Sept 2010 – Malta added to Frontier from being Unclassified
(7) 20 June 2011 – Czech Republic, Malaysia and Turkey promoted from Secondary Emerging to Advanced Emerging
(8) 19 March 2012 – Thailand promoted from Secondary Emerging to Advanced Emerging
(9) 18 June 2012 – Ghana added to Frontier from being Unclassified
(10) 22 June 2015 – Morocco demoted from Secondary Emerging to Frontier 22 June 2015 – Argentina demoted from Frontier to Unclassified
(11) March 2016 – Greece demoted from Developed to Advanced Emerging
(12) 20 September 2016 – Qatar promoted from Frontier to Secondary Emerging (effective in two tranches: 50% in September 2016 and 50% in March 2017) (13) 19 September 2016 – Latvia and Palestine added to Frontier from Unclassified
(14) 18 September 2017 - Argentina and Kazakhstan added to Frontier from Unclassified
(15) FTSE Russell announced the following country classification changes on 29 September 2017: Poland promoted from Advanced Emerging to Developed (effective from September 2018) Kuwait promoted to Secondary Emerging from Unclassified (commencing from September 2018)

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EMEA
+44 (0) 20 7866 1810

North America
+1 877 503 6437

Asia-Pacific
Hong Kong +852 2164 3333
Tokyo +81 3 3581 2764
Sydney +61 (0) 2 8823 3521