



# Capital Markets Infrastructure Risk Ratings: Middle East and Africa

**Thomas Murray** analyse capital markets infrastructure risk in the Middle East and Africa and review changes to regulation and market infrastructure within these regions

The capital market infrastructure risk rating (CMIRR) is a weighted average of six risk components which are asset commitment risk, liquidity risk, counterparty risk, financial risk, operational risk and asset servicing risk. The ratings are assigned to the market infrastructure as a whole, including all central securities depositories in the market, arrangements for settlement of physical securities, payment systems, and local regulations. The charts on the next page show the ratings for the Africa and Middle East markets.

The markets are of different complexity and size, and their central securities depositories (CSDs) operate at different degrees of sophistication with varying success in custody, settlement efficiency and risk mitigation. The markets where the CSDs operate more effectively to reduce custody and settlement risk exposures include Egypt, Israel, Jordan and Turkey in the Middle East region; and Mauritius, Namibia and South Africa in the African region. Generally, though, the African markets have less developed infrastruc-

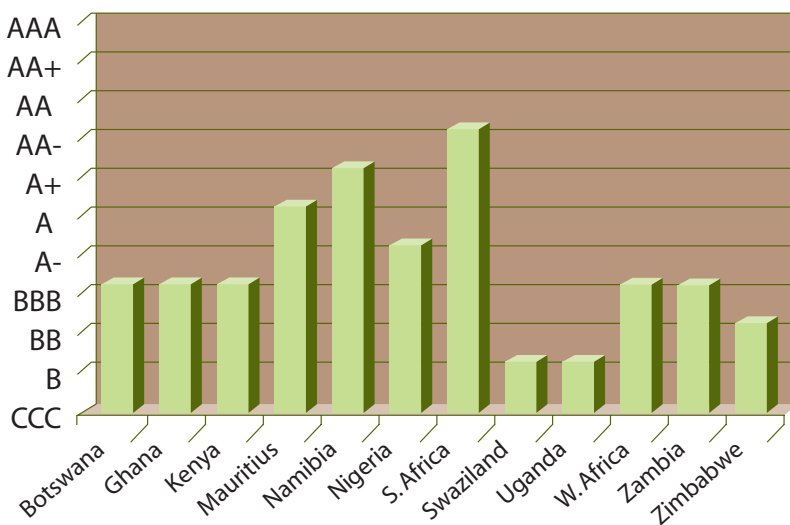
tures, as reflected by the ratings, with a number of markets rated between B and BBB.

This article will discuss three major developments in the region, notably initiatives to mitigate liquidity and counterparty risk exposure (as illustrated by the examples of Qatar and the United Arab Emirates), consolidation in market infrastructures (for example NASDAQ Dubai and DFM), and issues related to the political turmoil in the region (for example Egypt, Bahrain, Tunisia and the Ivory Coast).

## **Liquidity and Counterparty Risk Exposure**

A key development in global markets has been the implementation of measures designed to reduce liquidity and counterparty risk exposure. Within the Middle East, Qatar Exchange (QE), Abu Dhabi Securities Exchange (ADX) and Dubai Financial Market (DFM) have become more aligned with market best practices following the implementation of a delivery versus payment (DVP) settlement and optional

**Fig 1: Africa Capital Markets Infrastructure Ratings**



buy-in arrangement in May 2011. A DVP settlement is a mechanism by which delivery occurs if, and only if, payment occurs, and therefore provides a link between the transfer systems. However, the DVP settlement at QE, ADX and DFM is not considered to be a simultaneous DVP since the payment and settlement systems are not seamlessly connected. To mitigate the counterparty risk exposure, some developed markets have established a central counterparty (CCP), which is an entity that interposes itself between buyer and seller, becoming the buyer to every seller and the seller to every buyer through the process of novation. Within the Middle East and African regions,

only NASDAQ Dubai and the Tel Aviv Stock Exchange Clearing House (TASECH) act as CCP for on-exchange transactions.

The requirement for securities to be pre-validated prior to trading at QE, ADX and DFM, and the blocking of securities upon trade execution, effectively help mitigate failed trades and liquidity risk. QE, ADX, and DFM have also implemented a buy-in arrangement (although optional) as part of the fails management procedures for the broker to source the necessary securities to cover a short position in the event that the custodian invalidates or rejects the sell trade. Most markets in the Middle East and Africa have a buy-in arrangement in place.

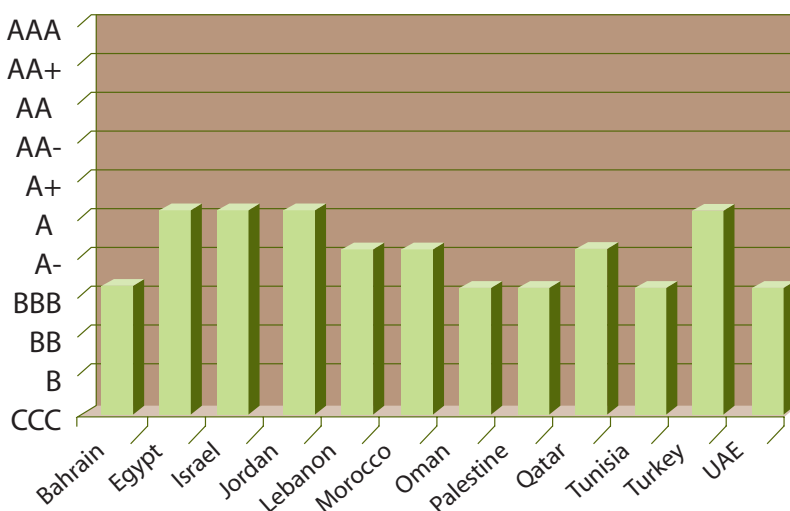
To increase market liquidity and facilitate fails management, QE, ADX and DFM plan to implement securities borrowing and lending (and short selling). Also the Egyptian market plans to implement same-day short selling in July 2011, with the Egyptian depository (MCDR) managing the lending pool. Mauritius, Turkey and South Africa are the only markets within the region to date that have implemented securities borrowing and lending.

**Consolidation in Markets**

The second significant development within the region has been the horizontal integration of infrastructures.

NASDAQ Dubai consolidated its key operational functions for equities (i.e. trading, clearing, settlement and custody) with DFM in July 2010. Earlier in May 2010, DFM acquired two thirds of the shares in NASDAQ Dubai from Borse Dubai and NASDAQ OMX. The consolidation was intended to make it easier for many of DFM’s 500,000 retail investors to trade NASDAQ Dubai stocks. The consolidation resulted in the settlement cycle for NASDAQ Dubai stocks being shortened from T+3 to T+2, in accordance with the settlement cycle in the DFM system. However, NASDAQ Dubai has now proposed to return to a T+3 settlement cycle for its listed stocks in order to allow foreign institutional investors more time to settle their trades and, subject to regulatory approval, the T+3 settlement cycle will be implemented in July 2011.

**Fig 2: Middle East Capital Markets Infrastructure Ratings**



Another example of consolidation can be seen with the merger of the Bond Exchange of South Africa (BESA) and the Johannesburg Stock Exchange (JSE) in June 2009. The merger was intended to provide higher liquidity in the market and generate economies of scale.

Within the African region, regional integration initiatives are being contemplated in order to increase market liquidity. One such initiative is the integration of Nairobi Stock Exchange, Uganda Securities Exchange and Dar es Salaam Stock Exchange. However, this initiative does not appear to have had momentum as there remain many obstacles such as differences in political and macroeconomic setups, cultural barriers, national sentiments, and currency issues. Yet a regional capital market infrastructure model exists in the West African French Franc Zone. There, the Ivory Coast, acting as the hub for the West African Monetary Union markets (Benin, Burkina Faso, Ivory Coast, Mali, Niger, Senegal, and Togo), operates a regional exchange (BRVM) and regional depository (DCBR) located in Abidjan. Obviously, having a single currency and a single central bank has facilitated the market consolidation.

### **Political Turmoil and the Market Impact**

The political turmoil that has spread across the North African and Middle East region since January of this year has had a significant impact on the markets which have struggled to remain open and function as normal. The situation has challenged the infrastructure, especially in terms of the financial and operational arrangements during this period. It is worth noting some of the ways in which the market was affected.

In the West African French Franc Zone, the regional infrastructure was directly impacted and the unstable situation led to the activation of business continuity plans (BCP) when BVRM and DCBR relocated their operations to Bamako in Mali during the post-election crisis in the Ivory Coast. The use of the BCP was also required by the Bahrain bourse during the peak of the political protests in that country when employees were not able to access the main site.

These examples emphasise the necessity of having a properly located BCP site in place in order to carry out critical business functions. They also emphasise the need to consider carefully the appropriate location of the site, which need not be within national boundaries. Today, given the advance of technology, it is no longer necessary for an exchange, clearing house or CSD to maintain a BCP or back-up facility within national boundaries and examples are beginning to emerge where BCP facilities are being established outside of a country. One such example is DCV in Chile, which has recently established a BCP facility in the USA in association with DTCC. Furthermore, the desirability of establishing cross-border BCP facilities had been considered by the Africa and Middle East Depositories Association (AMEDA) in 2009. The recent events highlight the wisdom of such plans. Indeed one can only wonder whether the recent political turmoil in Tunisia and Egypt, where the markets were closed for periods, could have been helped by having cross-border BCP arrangements.

The long closure period (about seven weeks) in Egypt highlighted the need for infrastructure to have appropriate plans for disruption and market closure. It is not just the BCP arrangements that need to be established and tested, but there also needs to be adequate financial resources which should be stress tested. The Egyptian infrastructure was able to maintain its workforce and other financial commitments during the lengthy closure period, in part because of the financial resources they held.

In general, the African and Middle East region has not traditionally been seen to be progressive within the global sphere. The difficulties these markets face, such as those witnessed during the recent political turmoil, help to explain the reasons for this lack of progress. Nevertheless, the markets are slowly addressing these issues and are moving to implement best market practices, such as DVP settlement, and to organise their markets through consolidation where this is feasible. ■

## Other developments in the Middle East:

### Bahrain:

- The Bahrain Stock Exchange has approved a proposal for the construction of a business continuity centre to meet business contingencies.
- A new exchange called Bahrain Financial Exchange was launched on 1 February 2011.

### Egypt:

- MCDR joined Link-Up Markets in November 2010.

### Israel:

- The Tel Aviv Stock Exchange Clearing House (TASECH) plans gradually to implement a SWIFT capability to improve the straight-through-processing of services.
- TASECH extended the settlement cycle for corporate bonds from T+0 to T+1 on 29 November 2010.

### Morocco:

- Maroclear implemented a new IT system in September 2010, which includes the following features: gross settlement for broker-to-broker trading, automation of processes including registration, a dedicated platform for repo transaction management, and segregation of accounts by client at CSD level.

### Oman:

- The Muscat Clearing & Depository Company (MCD) plans to implement a new settlement system, known as 'The Universal Clearing, Settlement and Depository System (UCS)'. The expected launch date of the UCS is Q2 2012.
- In April 2011 MCD introduced a new online connection facility that allows custodians to connect electronically to the depository's system.

### Turkey:

- The Istanbul Stock Exchange launched the interbank repo market on 7 January 2011.

## Other developments in Africa:

### Botswana:

- The BSE implemented a Central Securities Depository in 2008 for the clearing and settlement of equities.

### Ghana:

- The Ghana Securities Depository Company (GSD) was established in 2008. GSD is a wholly owned company of the Ghana Stock Exchange.
- The Ghana Stock Exchange implemented the Automated Trading System in 2009.

### Kenya:

- The settlement cycle for equities was shortened to T+3 on 4 July 2011.
- The Central Bank of Kenya introduced a horizontal repo market for inter-bank participants in September 2008.

### South Africa:

- The dematerialisation of money market instruments and the project to implement a T+3 settlement cycle continues to progress.
- STRATE joined Link-Up Markets in November 2010.

### Uganda:

- The Uganda Securities Central Depository was established on 18 February 2010.

### Zimbabwe:

- The commencement of operations of the Chengetedzai Depository Company in Zimbabwe, which was expected to take place in June 2011, has been postponed.

### CMIRR Ratings Definitions:

AAA	extremely low
AA+	} very low
AA	
AA-	
A+	} low
A	
A-	
BBB	acceptable
BB	less than acceptable
B	quite high
CCC	high
CC	very high
C	beyond any acceptable level of risk exposure