The new gatekeepers of financial claims: States, passive markets, and the growing power of index providers

Jan Fichtner, CORPNET Project, University of Amsterdam

Eelke Heemskerk, CORPNET Project, University of Amsterdam

Johannes Petry, SCRIPTS Cluster of Excellence, Free University Berlin

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Abstract:

Since the financial crisis there has been a massive shift from actively managed funds to passive funds that merely replicate financial indexes. Instead of active investors influencing states through their investment decisions, in this new economic reality the locus of agency is shifting from investors towards index providers as they decide which companies and countries are included into key benchmark indexes. We argue that the major index providers (MSCI, S&P Dow Jones and FTSE Russell) exercise growing private authority as they steer capital via their indexes. Index providers have become crucial intermediaries in the relationship between states and investors. Through producing widely used indexes, index providers essentially provide a crucial infrastructure that enables the creation and trading of increasingly passively allocated financial claims. Through the infrastructural power they derive from this gatekeeper position, index providers are able to ‘standardise’ the issuers of capital claims and the countries in which these issuers reside through determining the criteria that corporations and states, especially emerging markets, have to fulfil to qualify for index membership – and consequently asset allocation. This chapter therefore investigates the relationship between states and index providers and the latter’s influence on issues of domestic financial regulation, investor access and international capital flows.

1. Introduction

In the past, most governments had to brace themselves for the eventuality that ‘bond vigilantes’ (Arbogast 2020; Rommerskirchen 2019) or hedge fund ‘wolf packs’ (Fichtner 2013a, 2013b) could suddenly move financial markets in one direction or another. Interest rates of sovereign debt could quickly move up or domestic stock markets could plummet in a short amount of time as ‘hot money’ rushed in and out of national financial systems, thereby strongly interfering with countries’ economic and social policies (Harmes 1998; Roos 2019). This was particularly the case for small and developing countries – or ‘emerging markets’ in the parlance of international investors – because foreign investors mainly from Western countries had enormous assets under management compared to the size of these national economies. In this setup, public international financial institutions, mainly the World Bank and IMF, were often crucial gatekeepers in processes of capital reallocation and the enforcement of financial claims.

Today, following a set of rapid and fundamental changes in international finance, these same governments face another counterpart that has the power to move markets. These new and powerful kids on the block are the financial firms that create, maintain and sell key stock indexes. Only three of them dominate this growing and highly profitable sector: MSCI, S&P Dow Jones Indices and FTSE Russell, each accounting for about 26% of global index industry revenues.

In this chapter we will argue and show how the major index providers have become crucial gatekeepers of capital, yielding infrastructural power over international investments. They have become key counterparts to states in global finance, and their central position in the index investing ecosystem confers them the role of new *de facto* private regulators that exert standard-setting power (Petry, Fichtner & Heemskerk 2021). Through their country classification methodologies, in- and exclusions, and watch lists, index providers are *steering* financial claims whereby they influence domestic financial regulation, investor access and international capital flows in developing countries. Next to the World Bank and IMF, index providers are thus emerging as private authorities that are at times able to impose *de facto* conditionalities.

This has not always been the case; in fact, the infrastructural power of index providers only came about after a recent but fundamental shift in the organisation of global finance: the shift from active to passive investing. Since the global financial

crisis of 2007-2008 active investors are increasingly being supplanted by the passive investment ecosystem. Passive investment means that asset owners (e.g., pension funds, high-net-worth-individuals or small retail investors) invest their money in financial products that simply replicate well-known benchmark indexes, such as the S&P 500 or the MSCI World Index in the equity segment, and the Bloomberg Barclays Global Aggregate Index or the J.P. Morgan Emerging Market Bond Index in the fixed income space. The appeal of these passive index funds is that they charge far lower fees than actively managed funds, while generating mostly the same (or higher) returns. As a result, a growing herd of investors has been migrating from active funds to the passive asset management ecosystem.

Between 2006 and 2018, globally about US\$3,200 billion have exited actively managed equity funds, while more than US\$3,100 billion have entered index equity funds (Sushko & Turner 2018; Henderson 2019) – a hitherto unprecedented mass-migration of capital from active to passive funds, which are mostly managed by BlackRock, Vanguard and State Street (Fichtner & Heemskerk 2020). By mid-2019, the assets of US equity index funds exceeded the assets of actively managed equity funds for the first time (Gittelsohn 2019). As a result, we have entered what we have called the ‘age of passive asset management’ (Petry et al. 2021; see also Braun 2016, 2020; Fichtner, Heemskerk & Garcia-Bernardo 2017; Haberly, MacDonald-Korth, Urban & Wójcik 2019; Jahnke 2019). The recent coronavirus pandemic has not reversed this trend – if anything it has accelerated it, as bond index funds have witnessed record inflows in 2020 (Wagner and Ballentine 2020).

Under this new reality, the role of index providers in the investment chain is fundamentally transformed. In the past, their indexes primarily served informational purposes. An index such as the American S&P 500, the German DAX or the Japanese Nikkei was primarily a numerical representation of a particular stock market. Indexes served as benchmarks against which analysts could gauge the performance of stocks. While the decisions of index providers had some influence on actively managed funds, the rise of passive investing transformed their role profoundly. Index funds in effect delegate their investment decisions to index providers. As a consequence, they de facto ‘steer’ capital as inclusions of companies or countries to key indexes causes inflows of many billions of US\$ while exclusions can lead to large quasi-automatic outflows (Petry et al. 2021). Index investing thus represents a form of ‘delegated management’. Crucially, these in- and exclusions come with a wide range of

discretionary decision making, with a ‘flow through effect on the investor’s portfolio’ (Robertson 2019, 843). As Howard Marks of Oaktree Capital underscored: ‘somebody is making very active decisions about which stocks will be in each “passive” product. [...] The people who create the indexes are deciding which stocks will be invested in’ (Alloway et al. 2017).

Index providers have now become crucial gatekeepers in the infrastructure of international financial claims, because they determine the criteria that states, especially emerging markets, have to fulfil to qualify for index membership, while investors are increasingly delegating their investment decision-making power to them. Index providers essentially provide a crucial infrastructure that enables the creation and trading of increasingly passively allocated financial claims (see also Petry 2020b).

Through the infrastructural power they derive from this gatekeeper position, index providers are able to ‘standardise’ the issuers of capital claims and, as we try to show in what follows, the countries in which these issuers reside. This has far reaching implications because it attributes the three dominant index providers with the power to shape the conditions under which actors are allowed into the global financial system. Historically, such gatekeeper functions in the international financial system were privy to hegemonic or imperial states, in close cooperation with private finance. Since the end of Bretton Woods, the IMF and the World Bank have tried to fill this gatekeeper position. In this chapter we argue that today index providers have such a central position in international finance as *de facto* private regulators which exert standard-setting power that it begs the question to what extent they have become functional equivalents of the Bretton Woods institutions.

This chapter investigates the prominent role that index providers play today in order to better understand what their role may be in the (near) future. In particular we aim to dissect the influence of index providers on domestic financial regulation, investor access and international capital flows. To this end, the following section gives an overview about the development and the characteristics of index providers and elaborates on the role of index providers as intermediaries in financial claims. Section three subsequently discusses how index providers impact states, *inter alia* via their country classification methodologies, in- and exclusions, and watch lists. We analyse these developments using secondary literature, financial news and index methodologies, as well as 16 expert interviews with index providers, exchanges and asset managers conducted between July 2017 and September 2019. In the final

section we take stock and reflect in order to better determine how the organisation of global financial authority is currently changing. While certainly not similar, we see striking functional equivalents between index providers and the Bretton Woods institutions.

2. Index providers and financial claims

In essence, indexes are numerical tools that enable the comparative evaluation of (groups of) assets over time. The purpose of indexes is to display the performance of a specific economic entity such as a nation's stock market (S&P 500) in one single number that is relatively easy to understand and comparable over time. As such indexes consist of a series of corresponding dates and numbers, evaluations based on a series of assets (e.g., stock or bond prices) with specific weightings, whose sequence depicts the performance of the evaluated assets (Robertson 2019). Thereby, indexes demarcate the boundaries of what these entities are: the 500 companies that the S&P 500 evaluates are (perceived as being) synonymous with the US stock market.

Crucially, constructing indexes is not a purely technical exercise. The 'veneer of numerical representation' (Broome & Quirk 2015, 829) conceals the normative values and assumptions underlying their calculation as index providers have significant discretion in devising their methodologies. Their notions on what constitutes 'good' corporate governance at the level of the firm and a 'favourable' investment environment at the level of (national) markets helps or hinders firms and countries in attracting capital, essentially deciding what is investment-worthy in global financial markets (Petry et al. 2021). By deciding what to include into/exclude from an index and how to calculate these, index providers play an important role as they increasingly define 'the norms of what's considered acceptable in international finance' (Alloway et al. 2017). This combination of standard-setting and legitimate decision-making power means that index providers have gained a position of private authority in capital markets, providing these private financial actors with the capabilities and positions of power as gatekeepers of capital.

This gatekeeper role of index providers in international finance is relatively novel and the last step in a longer period of transition. With the shift in global finance from banks to capital markets, indexes became more relevant as information tools tracking the development of financial markets (Campbell-Verduyn 2016). First, this led

to the emergence of a few indexes as recognised benchmarks by those index providers that had positioned themselves to ‘provide the right concept at the right time for the market’.¹ Second, investors wanted to compare performance between markets in a transparent and trustworthy manner. This gave rise to globally comparable equity indexes, for instance by MSCI, which ‘investors really like because you can separate the globe into individual, comparable pieces’.² Furthermore, in the 1980s derivatives exchanges such as CME in Chicago and LIFFE in London started launching index futures and options, gradually increasing their importance as reference prices for underlying assets (Millo 2007).

A few index providers enjoyed considerable brand recognition, some indexes became synonymous with the markets they aimed to represent, and index futures enabled risk management for those markets. Moreover, many actively managed funds used them as baselines to compare their performance. Therefore, indexes had at least some influence on asset managers as any deviation from the relevant index could be conceived as a kind of risk management metric. However, indexes only loosely anchored asset allocation as most fund managers had discretion in choosing both the *degree* of replicating an index as well as the *time period* for doing so. As one interviewee noted, back then ‘the propagated characteristic of active management was to be different from the index [...] to beat the index’.³ Hence, the decision-making power of index providers over the composition of their indexes had relatively limited impact as it intermediated capital flows very indirectly. Thus, at that time, the main function of indexes was to provide market information; their exact composition was not yet crucial to investors, listed companies or countries. This changed fundamentally with the rise of passive investing in the mid-2000s. Index providers began to influence capital flows in an *immediate* and *comprehensive* way. Being a central component of the index funds ecosystem conferred them – gradually and only as a side-effect of their business model – a position of growing private authority in financial markets (Petry et al., 2021).

The financial crisis triggered two reinforcing trends that transformed index providers from merely supplying information to exerting authority. First, the global index industry concentrated, which led to a growing power position of a few major index providers. The second and more consequential trend was the money mass-migration towards passive investments, which significantly increased the nascent authority of index providers as evermore funds directly tracked their indexes, such as

the S&P 500 or the MSCI World. Increasingly, investments were not actively managed by fund managers but passively invested into index mutual funds and ETFs (Braun 2016, 2020; Fichtner 2020, Fichtner et al. 2017; Haberly et al. 2019; Jahnke 2019). This makes sense as the vast majority of actively managed funds have not been able to beat benchmark indexes over longer periods of time, while charging substantially higher fees than index funds (SPIVA 2019). Whereas in the past indexes only loosely anchored fund holdings around a baseline, now they had an instant, ‘mechanic’ effect on the holdings of passive funds, thereby ‘steering’ capital flows.

Today, index providers de facto steer the giant passive investment capital flows. But index providers have a steering effect over active managed funds as well. Established and well-known indexes are increasingly used as direct benchmarks by actively managed funds which measure their performance against these indexes, and which thus are crucial as investment baselines. Benchmarking against indexes has reached enormous proportions: US\$14.8 trillion, US\$16 trillion and US\$8.9 trillion of assets (equities and bonds) was benchmarked against the indexes of MSCI, S&P DJI and FTSE Russell in 2017/18, respectively. This is up from US\$7 trillion (MSCI), US\$7.1 trillion (S&P DJI) and US\$7.1 trillion (FTSE & Russell) in 2013 (Pettry et al. 2021, 161).⁴ Therefore, the rise of passive management also increases the authority of index providers vis-à-vis active management because by steering evermore passive capital index decisions now mechanically move ever larger parts of the markets, creating a ‘pull effect’ that actively managed funds need to follow.⁵ This means that not only passive funds shift their investment according to reclassifications by index providers, but also active funds that are benchmarked against established indexes (Raddatz et al. 2017).

2.1. Mediating financial claims

With the ongoing shift from active to passive investing, index providers have become a vital component of a changing global financial system – the ‘infrastructure of the infrastructure’ of the global economy (Cerny 1994). From their previous role as mere information providers for capital markets they have become central actors of passive asset management that exert de facto standard-setting power in global financial markets. Index providers have thus become crucial *intermediaries* or *gatekeepers* in the relationship between states and (increasingly passive) markets. Of course, index providers do not hold financial claims themselves as they do not own stocks or bonds.

Instead, similar to listed companies, a separation between the management and the ownership of financial claims is emerging. While big asset managers such as BlackRock, Vanguard and State Street are the de facto owners of these claims (on behalf of end-investors), investment decisions are increasingly taken by index providers on their behalf.

Similar to payment system providers (Nölke, this volume) and clearinghouses (Thiemann, this volume), index providers are private financial actors that organise the infrastructural arrangements which enable the functioning of financial markets (Petry 2020b, 11-13). An index can be understood as a formula that specifies which assets are to be held by investors through index funds/ETFs and more indirectly through benchmarking practices. However, as Bernards and Campbell-Verduyn (2019, 783) note, such financial infrastructures ‘can confer, extend and enable new forms of governance’. By deciding which assets become parts of these baskets of financial claims amidst increasingly passive investment flows, index providers make decisions about the composition of investors’ balance sheets.

From a relational perspective the major index providers are intermediaries between the creditors or claim holders and the debtors or claim issuers (see figure 5 in chapter 1). The ultimate creditors or claim holders here are investors, which for the index providers take the shape and form of ‘the’ investment community. This community is dominantly Western or Anglo-American in origin although not exclusively. It is up to the index providers to ensure that the indexes they create are considered by the investment community as a fair and proper reflection of ‘the market’. This means negotiating a fine line between – for instance – in- and excluding firms based on good corporate governance practices on the one hand or on financial performance on the other.

At the other side of the financial claims which the index providers mediate stand the debtors (or claim issuers) – the firms or governments that seek access to international capital. This is a diverse group compared to the creditor/claim holder side of the equation, and what the major index providers essentially do is to classify which debtors or claim issuers (companies, governments) are of enough ‘quality’ to grant them the status of index-worthiness. In what follows we are particularly interested in the leverage that index providers thereby have over governments.

2.2. Index providers in the hierarchy of global finance

A large literature has focused on international investors and their relationship to national governments (Rommerskirchen 2015, 2019; Hardie 2012; Maxfield 1998; Haggard & Maxfield 1996). However, this relationship is highly unequal between countries. Some states – most notably the US – derive power from the global dominance of institutional investors (Konings 2007, 2009). After all, most global investors are Anglo-American entities (Fichtner 2017) and capital markets globally have transformed according to a script provided mainly by US-based financial and political interests (Carroll et al. 2019; Gabor 2020; Panitch & Konings 2009). As Konings (2007, 49-50) noted with respect to the Eurodollar markets ‘the creation of a highly integrated and liquid financial structure [through US financial institutions] enhanced America’s structural power’. Thereby, the Anglo-American investor community facilitates and perpetuates existing power relations and hierarchies within the global economy (Bortz & Kaltenbrunner 2018), reproducing US financial hegemony (Norrlof 2010; Panitch & Gindin 2012; Strange 1987).

While not necessarily gaining power like the US, other developed countries can at least thwart the influence of global investors (e.g., Goyer 2007). While the convergence of national capitalisms in the face of (financial) globalisation was heavily debated in the 1990s and 2000s (Berger & Dore 1996; Strange 1997; Lane 2003), at least with respect to developed countries, some scholars argue that national capitalist diversity among OECD countries has persisted despite global financial pressures (Maxfield et al. 2017; Mosley 2003; but see, Streeck 2010; Hay 2020).

However, this is markedly different for developing and emerging economies (see Koddenbrock, Kvangraven & Sylla, this volume). As Mosley (2000: 3) noted, ‘in the developing world [...] the influence of financial markets on government policy autonomy is more pronounced’. These countries are situated at the lower rungs of global financial hierarchies and are much more prone to changing investor sentiments (Alami 2018; Kaltenbrunner & Paineira 2018; Naqvi 2019). As Bonizzi and Kaltenbrunner (2018) argued, the mismatch between institutional investors’ USD-denominated claims and emerging market assets facilitates more volatile investment allocation behaviour on behalf of what are often perceived as the most risk-averse international investors. Similarly, high yields make emerging markets also very attractive for more risk-friendly investors such as hedge funds (Musthaq 2020). Reversely, emerging market governments have a series of incentives to comply with global creditors (see Roos 2019).

For a long time, the Bretton Woods institutions, IMF and World Bank, were important gatekeepers and intermediaries in the relationship between investors and governments. This gatekeeping role was usually linked to conditionalities that forced countries to adopt liberalisation policies. Even though they only injected 'small' amounts of capital into these economies, their conditionality-based investments were seen as votes of confidence by international investors which then often followed suit with more substantial investment flows (see Saravia & Mody 2003). Increasingly, however, index providers define what is investment-worthy, and now arguably play a functionally equivalent role in mediating these creditor-debtor (or claim-issuer-claimholder) interactions.

As the IMF (2017, 55-56) notes, 'a financial claim is an asset that typically entitles the creditor to receive funds or other resources from the debtor under the terms of a liability' where 'each claim is a financial asset that has a corresponding liability' (see also, Braun & Koddenbrock, this volume). Importantly, both bonds and equities are therefore considered financial claims between two entities: bonds constitute a claim on the basis of a repayment of credit, while stocks 'represent a claim of the owner on the residual value of the entity after the claims of all creditors have been met' (IMF, 2017, 55). And while these bonds and stocks might be securities issued by emerging market companies, these companies are situated within individual countries which create the rules and regulatory frameworks for their national securities markets and these claims consequently influence national policies.

In the new age of passive asset management, the locus of agency has shifted towards index providers as they increasingly decide which companies and countries are included into key benchmark indexes. The major index providers bundle many financial claims in their indexes and therefore are an attractive and powerful counterpart for debtors seeking financial inflows. The traditional dyadic relationship between states and investors is therefore transformed in such a way that index providers now have become key counterparts to states, on behalf of 'the' investment community they 'represent'. By deciding on the demarcations of investment entities, they define what an investment looks like. This applies both to broad investment categories such as 'emerging markets' or 'developed markets' where they define which countries qualify as one or the other as well as to specific benchmark stock indexes, such as the MSCI World, where they decide the criteria that states, especially emerging markets, have to fulfil to qualify for index membership which influences

issues of domestic financial regulation, investor access and international capital flows. How countries are (1) categorised into specific country classifications, under which circumstances they are (2) included or (3) excluded and (4) whether they are put on a watch list are crucial aspects of this process. The remainder of this chapter investigates these different aspects of how index providers shape the financial claims between states and (passive) markets.

3. How index providers impact states

3.1. Country classifications

Through their country classifications, index providers facilitate the standardization of financial claims. While indexes are composed of the stocks of individual companies, each of these companies is listed on an exchange, which is situated within a country that creates the rules and regulatory frameworks for its national stock market. By deciding over which stocks or bonds are included into their indexes, the major index providers decide which debtors (i.e., corporations and countries or markets) are allowed in.

This is especially relevant for emerging economies as they bear the brunt of skittish investor behaviour (Bonizzi & Kaltenbrunner 2018). Through index investing the investment decision to enter or exit markets has been delegated to index providers and their seemingly ‘technical’ criteria; as one index provider noted ‘we look at country classification just as a mechanical tool to access markets’.⁶ By reclassifying individual countries, index providers effectively redraw the borders of markets. Moreover, index providers set out the criteria that decide which countries are ‘investment-worthy’, thereby defining the hierarchy in global financial markets.

For developing countries, being part of an index is important as this attracts international investment into their ‘under-developed’ stock markets, not only funding their domestically listed companies but also raising their international profile. Index inclusion is an accolade for countries as the inclusion signifies and establishes the international investment community’s trust into their economy.⁷ As one interviewee noted: ‘Obviously for any economy the no.1 aspiration for a government is to create the economic conditions to attract foreign investments. [...] So being included in a broad index is essential.’⁸ But as argued above, seemingly objective index calculation is based upon normative assumptions about the nature of markets, which, first and foremost, should be freely accessible for international investors. After all, the

composition of the index needs to reflect to a certain extent a status quo in the investment community so that the index is considered to be a valid reflection of ‘the’ market. By setting out these criteria, index providers thus formalise and shape the norms of global finance. Index providers decide whether to include countries into their indexes and whether to classify them as ‘frontier’, ‘emerging’ or ‘developed’ markets.⁹ As one interviewee put it: ‘the big index providers, they are setting standards! [...] Before, nobody paid attention, but now so much money follows them, [...] they have a lot of political power!’¹⁰

Table 1. MSCI Market Classification Framework (Source: MSCI, 2020b).

Criteria	Frontier	Emerging	Developed
<u>Economic development</u> (Sustainability of economic development)	No requirement	No requirement	Country GNI per capita 25% above the World Bank high income threshold for 3 consecutive years
<u>Size and liquidity requirements</u> - No of companies meeting the following standard index criteria - Company size (full market cap) - Security size (float market cap) - Security liquidity	2 USD 700 mn USD 53 mn 2.5% ATVR	3 USD 1,400 mn USD 700 mn 15% ATVR	5 USD 2,801 mn USD 1,400 mn 20% ATVR
<u>Market accessibility criteria</u> - Openness to foreign ownership - Ease of capital inflows / outflows - Efficiency of operational framework - Competitive landscape - Stability of the institutional framework	At least some At least partial Modest High Modest	Significant Significant Good and tested High Modest	Very high Very high Very high Unrestricted Very high

While S&P DJI is the world’s largest index provider by revenue, this is mainly due to the crucial S&P 500 index. In contrast, MSCI is the largest provider for emerging markets equity indexes (Miyajima & Shim 2014). In the words of the Financial Times,

‘MSCI [...] in effect controls the definition of which countries are “emerging markets”’ (Authers 2018). Therefore, MSCI’s criteria for inclusion/exclusion are crucial for emerging markets. MSCI’s CEO even states that ‘there’s not a country that doesn’t call as soon as a review is announced’ (Wigglesworth 2019). These criteria are set out in MSCI’s Market Classification Framework (Table 1), comprising three elements: economic development; size and liquidity; and investor access. Economic development is not crucial as a criterion, neither are the size and liquidity requirements (only 2-5 companies need to meet minimum requirements).

Portugal’s tiny stock market, for instance, only has a market capitalization of \$89 billion and 36% of GDP, while South Korea has a market capitalization of \$2,333 billion and 133% of GDP with a much more advanced financial system as well as a six times larger GDP. Portugal, however, is classified as a ‘developed market’ while Korea is an ‘emerging market’ in MSCI and other index providers’ portfolios. Korea’s classification is largely the result of offshore restrictions on index trading as KRX, Korea’s exchange and provider of the country’s benchmark stock index, KOSPI, does not license its index to create offshore derivatives, essentially preventing speculators in offshore markets from influencing the stock price valuation of Korean companies while investor registration is also cumbersome and no offshore currency market exists (MSCI 2020b; Petry, Koddenbrock & Nölke 2021). Investor access is the dealmaker/breaker for country classifications, and it is this criterion on which most indexing decisions are based.¹¹

As MSCI (2020, 2) states, the criterion of market accessibility ‘aims to reflect international institutional investors’ experience of investing in a given market’, and its assessment is ‘based on qualitative measures’ that MSCI reviews for all markets at least once a year during its Global Market Accessibility Review. This provides MSCI with a great degree of discretion and ‘ample space for subjective judgement on whether certain countries should be considered frontier or emerging markets’ (Moreolo 2018); the same applies for their weighting within indexes. While index decisions about company inclusions are often more indirect and not targeted at individual companies, in the case of country reclassifications index providers take a much more proactive role.¹²

In order to affect classifications, countries ‘have homework to do’ and ‘boxes to tick’¹³ – simply talking with index providers is not sufficient, ‘they really need to make effective changes’.¹⁴ In 2019, for instance, an index reclassification of emerging

countries resulted in a 'seismic shift' of over US\$120 billion in active and passive fund flows (Robertson & Lam 2019). Hence, in the age of passive investing the reclassification of countries into 'developed,' 'emerging,' and 'frontier' markets can lead to billions of rapid 'automatic' in- or outflows by funds that track the respective indexes. With the move towards passive investing, the locus of agency between international investors and governments has therefore shifted. As this section argued, the actions and judgements of index providers can have important consequences for states – as is demonstrated in the following subsections.

3.2. Country inclusion: China

In June 2017, MSCI decided to (gradually) include China A-shares into its emerging market index which serves as a benchmark for investments worth US\$1.8 trillion, followed by FTSE Russell and S&P DJI in 2018. In early 2019, MSCI then announced to quadruple the weighting of Chinese A-shares to 20% using the confident slogan: 'emerging markets may never be the same' (Wright 2019). By March 2019, index inclusions had steered at least US\$84 billion of passive and active investment into China's stock market,¹⁵ with resulting long-term passive inflows estimated at US\$400 billion over the next decade (He 2018). This represented a milestone in China's opening process and an 'accolade' for its aspiration to becoming a global financial power and showcased increased recognition from the international investment community. One foreign exchange trader likened it to 'China's ascent into the Champions League' and 'basically the same message to asset managers as [the IMF's] SDR inclusion was to central bankers'.¹⁶

However, China's index inclusion was a quite contested and political process. Many observers suggested that Chinese regulators had to make concessions, with the main issue being guaranteed investor access to China's relatively closed market. As one interviewee noted, 'MSCI have actually accomplished quite a lot by the inclusion. It's amazing that it was an external, private organization that suddenly gets CSRC [China Securities Regulatory Commission] and government officials to bend and to agree to things that they would have never agreed to in any other circumstances'.¹⁷ As another interviewee highlighted, MSCI has a quasi-regulatory function – 'even though MSCI is not a regulator, companies need to abide by, to respect their rules'.¹⁸ Since the inclusion, MSCI for instance excluded several Chinese companies from their indices that suspended the trading of their shares as this violated market

accessibility.¹⁹ Over the years, MSCI has been in close contact with the Chinese authorities, advising regulators on how to regulate markets in order to meet inclusion requirements or informing Chinese companies about MSCI corporate governance standards.²⁰

Other observers, however, voiced concerns that the inclusion resulted from pressure by the Chinese government and MSCI's profit expectations through increased access to China.²¹ The *Wall Street Journal*, for instance, highlighted that Chinese stock exchanges threatened to cancel MSCI's access to Chinese market data in case of a non-inclusion, while Chinese asset managers allegedly halted ongoing cooperations with MSCI (Bird 2019). In addition, this unprecedented inflow of foreign capital will take place according to trading and investment rules set out by the Chinese state, including a level of market surveillance, guidance and intervention unthinkable in Western markets (Petry 2020a, 2020c). Because of the index inclusion, asset managers were 'forced into China'²² – with index providers as intermediaries in this relationship.

Whether MSCI or the Chinese government prevailed in this development is still up for debate. What becomes clear, however, is that China's inclusion into MSCI indexes was not a neutral technical exercise but a highly political process with a significant impact on the global allocation of financial assets that requires further investigation. It is important to note that few states have the power to contest index providers, with China (and the US) as possible exceptions to the rule. Most countries need to comply with index providers' rules due to their integration into global financial circuits – this becomes especially clear when it comes to index exclusions.

3.3. Country exclusions: Peru and Argentina

A telling example for the power of index decisions is the case of Peru which MSCI pondered to exclude from their 'emerging market' index and recategorize as 'frontier market'.²³ However, while the MSCI Emerging Markets index serves as a benchmark for funds worth \$1.8 trillion, its frontier market index is tracked by only \$4-14 billion.²⁴ Within a day following MSCI's announcement that it was considering moving Peru to its frontier markets index, the Peruvian stock market fell by 5% in one of the largest single-day losses. Cristian Laub, president of the Lima Stock exchange, estimated that in case of a reclassification, within three months \$1.5 to \$5 billion of international funds would exit the stock market, stating that 'if they tell us we're a frontier market, it will

take us between 7-10 years to become an emerging market again; that's why the situation is serious'.²⁵ The urgency of this situation was nicely captured by Alloway et al. (2017):

In September 2015, Peru's then-finance minister abruptly changed his plans and hopped on a jet to New York. By the time Alonso Segura Vasi landed in the U.S., officials from the country's central bank and securities regulator were also en route to join him. What prompted a bevy of Peruvian officials to make the eight-hour journey wasn't a matter of urgent statecraft or diplomacy. Instead, it was a rumour that [...] MSCI might oust the South American country from its widely followed emerging-markets index.

Eventually Peru managed to escape this fate by engaging in "roadshows with institutional investors 'to identify what were the necessary measures to strengthen liquidity and implement them'" (Doll 2019). These measures included the introduction of market maker incentives, changes in trading rules that eased algorithmic trading, enabled short selling and derivative trading and as well as eliminating the capital gains tax.²⁶ Peru has since been on a watch list and needs to continue its reform path in order to maintain its 'emerging market' status. What this episode demonstrates is the interlocking relationship between states and index providers, and the increasing private authority exercised by the latter.

Whereas Peru narrowly escaped a downgrade, the case of Argentina tells a different story. After Argentina imposed capital controls to prevent the depletion of foreign-currency reserves amidst a crisis of confidence that fuelled dollar outflows, MSCI excluded Argentina from its emerging market index (MSCI 2009). Since then, the Argentinian government engaged in renewed efforts to convince MSCI to also upgrade locally listed stocks from the frontier to the emerging market category, with measures such as replacing local brokers with global investment banks, upgrading its trading infrastructure and most importantly to "imitate Peru" (Doll 2019) – by cosying up to international investors, adhering to their standards, and trying to win back the favour of the major index providers. Further, between December 2015 and January 2017 capital controls were mostly dissolved (table 2). Following these regulatory changes, MSCI reclassified Argentina to the Emerging Markets index during their

Semi-Annual Index Review in May 2019,²⁷ resulting in capital inflows of about \$3.8 into Argentina's stock market as estimated by JPMorgan.²⁸

Table 2: regulatory changes in Argentina.

restrictions	before December 2015	by January 2017
minimum period during which investments must stay in the country	365 days	removed
mandatory cash deposit applied to USD inflows	30%	removed
maximum limit for repatriation of funds from the same of equity securities	USD 500,000 per month	removed
approval from the central bank for repatriation of funds	required and with certain conditions	removed

As these examples demonstrate, the decisions of index providers to include or exclude countries into an index or move them from one index category to another have significant consequences for both investor capital flows as well as national policies and the design of regulatory frameworks. The major index providers steer capital and negotiate (or in some cases arguably dictate) the conditionalities of financial claims between states and (passive) financial markets.

3.4. Country watch lists: Korea, Brazil, India and Turkey

Country inclusions and exclusions, however, are only an ultimate solution for index providers to exercise their power. A probably even more effective instrument in their toolkit is placing countries on a watch list. These watch lists have a dual purpose. On the one hand, they have an encouraging effect on countries that are under consideration for an inclusion or upgrade (e.g., from frontier to emerging market) – if countries' stay on their reform path, they will soon reap the benefits. On the other hand, if countries are 'misbehaving' they will be considered for a downgrade or exclusion and watch lists thus have a disciplinary effect. While in the era of active markets the threat of an investment strike kept states at bay (Gill & Law 1989), today the threat of an index reclassification through index providers facilitates this new constitutionalism. By placing countries on watch lists for inclusions, exclusions or reclassifications, index

providers create incentives for states to comply with their rules, again acting as key gatekeepers.

This is a very similar pattern to the effects of rating outlooks issued by the major credit rating agencies (Sinclair 2005). Essentially, if a large index provider places a country on a watch list it has a similar effect as when a rating agency gives a country a negative credit outlook. It is a warning sign to comply with the rules set out by the market authority or to suffer the negative consequences, i.e. the eventual downgrade and the following outflow of investments. Korea, Brazil, India and Turkey, for instance, are on MSCI's 'watchlist' of countries that could be downgraded if they do not ease investor access (MSCI 2018; Tan & Robertson 2018), highlighting the need to comply with the rulebook drafted by the major index providers.

In the case of Turkey, a series of bans on stock lending and short selling caused MSCI to consider downgrading Turkey to a 'frontier' market. MSCI (2020a) noted that these steps 'severely restrict the ability of institutional investors to express active investment views and hedge portfolio risk' and that Turkey might be reclassified 'if the already deteriorating accessibility level of the Turkish equity market were to worsen further'. Emre Akcakmak, a Dubai-based portfolio manager at East Capital, noted that a reclassification as frontier market would be a 'loss of prestige' for Turkey, as 'its place is next to India, South Africa, Indonesia, Thailand – not next to some of the less developed and smaller frontier markets' (Pitel 2020). While Turkey has not yet been reclassified, its weighting of the MSCI Emerging Market index was reduced from 0.5% in April 2020 to 0.28% in April 2021. This essentially represents a slap on the wrist by the index provider, with a possible reclassification looming in the background that is expected to trigger about \$5 billion in total outflows from Turkish equities, including about \$2-3 billion from passive investment funds that automatically track the index.

Watch lists have an intermediary function that signal to both investors and governments whether and under what conditions the current investment equilibrium might be changing. Placing a country on a watch list can also make investors nervous and especially active investors might already exit a market before a possible downgrade, only increasing the pressures on the respective country's government to comply with the investment conditions set out by the major index providers. The threat of a downgrade or the promise of a potential upgrade therefore already influence the actions of states and markets.

4. Conclusion

In the past, so-called 'bond vigilantes' have frequently impacted sovereign debt markets, demanding higher yields whenever inflation expectations shot up. In their heyday during the 1980s and 1990s they strongly influenced US economic policy, while during the eurozone crisis bond vigilantes drove interest rates up for countries such as Italy and Spain to such an extent that they nearly faced a sovereign default. According to the Oxford Dictionary, a vigilante is 'a member of a self-appointed group of citizens who undertake law enforcement in their community without legal authority, typically because the legal agencies are thought to be inadequate.' Bond vigilantes thus can be seen as a kind of financial market 'militia' that takes the law into their own hands, so to speak, in order to punish states that 'live beyond their means.' Packs of bond vigilantes do not follow specific rules and their behaviour is rather erratic, which is also why they are referred to as 'hot money'. The IMF and World Bank were gatekeepers in this previous setup as much as they stepped in during moments of crises, imposed conditionalities on crisis-ridden countries and injected capital to prevent a worsening of the respective countries' financial position, thereby maintaining the status quo of financial claims between debtors and creditors.

The rise of the index investing ecosystem is slowly but steadily supplanting the species of the bond vigilantes while simultaneously also taking on a role as gatekeepers that is (to some degree) functionally equivalent to the Bretton Woods institutions. First, a global financial habitat dominated by passive index funds is structured by different rules and logics. Foreign money that enters emerging markets via index funds is arguably not erratic, 'hot money' but rather sticky, 'cold' money. Investors in such funds have delegated their investment decisions to the respective index provider and are therefore not able to sell stocks or bonds of individual countries they may perceive as overly risky. What is still possible, though, is that due to an investor panic there is a general rush out of emerging markets. Furthermore, there are indications that index funds make emerging markets more sensitive to financial conditions in the 'Global North' (Converse et al. 2020).

Instead of erratic in- and out-flows into/from single countries, reallocation through indexes occurs in a more orderly fashion, largely determined by the index providers' schedule of market classification and weighting reviews. This may provide developing countries a certain amount of stability, or at least some transparency over investor behaviour. Increasingly, countries are not anymore facing an unpredictable

pack of foreign investors, but their counterparts are three major Anglo-American index providers whose decisions are more or less rule-based and thus predictive to a certain extent. If vigilantes are aggressive and erratic, the nature of index providers is almost diametrically opposed – rational and relatively rule-based, albeit their rules are based upon certain normative assumptions about how capital markets should function. With a bit of imagination, they could be called the new global finance ‘bailiffs’ – actors who are vested with growing (private) authority that act on behalf of the international investor community.

Most small and developing states are well aware that they have to fulfil the criteria for market accessibility for foreign investors set by the three major index providers. Moreover, states and markets are well aware that the decisions of these index providers to include or exclude countries have become very consequential in this new age of passive investing. Rather than the IMF and World Bank which often only engaged with countries in moments of crises, index providers fulfil their role as gatekeepers more directly and permanently – constantly monitoring markets, their improvements and deviations from the rules set out in their methodologies and acting on these changes in regular intervals. It might be the case that in this new era of passive asset management financial flows in and out of developing countries will become more ‘orderly’ due to the rising importance of index investing. However, this does not at all mean that the global financial system is becoming less hierarchical – on the contrary, the major index providers are quickly turning into powerful gatekeepers that mediate international financial claims between creditors and debtors.

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Notes:

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- ¹ Interview: Senior managing director, index provider (Zurich, 23 August 2019).
- ² Interview: Business development, exchange (Hong Kong, 19 August 2019).
- ³ Interview: Head of research, index provider (Frankfurt, 20 August 2019).
- ⁴ Moreover, there is a substantial proportion of equity funds that officially are actively managed but do not actually deviate much from their benchmark indexes. This is referred to as ‘closet indexing’ or ‘index hugging’, and it is estimated that in the EU between 5-15% of all equity funds could fall into this category (ESMA, 2016).
- ⁵ Interview: Head of research, index provider (Frankfurt, 20 August 2019).
- ⁶ Interview: Senior managing director, index provider (London, 3 September 2019).
- ⁷ Interview: Senior managing director, index provider (London, 3 September 2019).
- ⁸ Interview: Senior managing director, index provider (Zurich, 23 August 2019).
- ⁹ Country classification schemes are relatively similar: MSCI and S&P DJI (Frontier; Emerging; Developed) and FTSE (Frontier; Secondary Emerging; Advanced Emerging; Developed) (FTSE, 2019; MSCI, 2020b; S&P DJI, 2018).
- ¹⁰ Interview: Business development, index provider (Hong Kong, 27 September 2018).
- ¹¹ Interview: Research department, index provider (Shanghai, 23 September 2019).
- ¹² Interviews: Head of research, index provider (Frankfurt, 20 August 2019) and senior managing director, index provider (Zurich, 23 August 2019).
- ¹³ Interview: Head of research, index provider (Frankfurt, 20 August 2019).
- ¹⁴ Interview: Research department, index provider (Shanghai, 23 September 2019).
- ¹⁵ Observation: MSCI ‘China and the future of equity allocations’ Webinar (14 August 2019).
- ¹⁶ Interview: FX trading desk, global bank (Frankfurt, 25 January 2018); also, interview: hedge fund manager (Hong Kong, 27 June 2017)

¹⁷ Interview: business development, index provider (Hong Kong, 27 September 2018).

¹⁸ Interview: International department, exchange (Shanghai, 26 April 2018).

¹⁹ Interview: research department, index provider (Shanghai, 23 September 2019).

²⁰ Interviews: international department, exchange (Shanghai, 26 April 2018), general manager, exchange (Hong Kong, 27 September 2018) and research department, index provider (Shanghai, 23 September 2019).

²¹ Interview: business development, global exchange (Hong Kong, 7 July 2017).

²² Observation: Orient Securities-Hong Kong Exchange Group investor presentation (Hong Kong, 6 July 2017).

²³ see:

<https://www.msci.com/documents/1296102/2907491/Consultation+on+a+Market+Reclassification+Proposal+for+the+MSCI+Peru+Indexes/691d9a13-48cb-43f4-993b-e2b9f381a248> (last accessed 16 November 2020)

²⁴ There is no exact data available for how many investors track individual indexes, with estimates ranging from \$4 billion (<https://e.vnexpress.net/news/business/phat-dat-realtor-proposed-to-msci-frontier-market-100-index-4187766.html>; last accessed 16 November 2020) to \$14 billion (<https://perureports.com/lima-stock-exchange-falls-5-on-reclassification-fears/1977/>; last accessed 16 November 2020).

²⁵ see: <https://oxfordbusinessgroup.com/overview/tough-times-reforms-under-consideration-are-likely-increase-liquidity-and-trade-volumes> (last accessed 16 November 2020).

²⁶ see: <https://oxfordbusinessgroup.com/overview/tough-times-reforms-under-consideration-are-likely-increase-liquidity-and-trade-volumes> (last accessed 16 November 2020).

²⁷ https://app2.msci.com/eqb/pressreleases/archive/MSCI_May19_QIRPR.pdf

²⁸ <http://www.berettagodoy.com/newsletter/argentina-regains-emerging-market-status/>