BANK OF ENGLAND

Speech

Equity Indices and Europe

Speech given by

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The inauguration of these awards is an eloquent symbol of how internationalised equity markets are becoming. This has of course always been true for really large companies, many of which have for long generated their profits in a range of different economies. But as barriers to doing business cross border come down - not just in Europe, though that is the most obvious example - I think it will become increasingly common to view a whole range of companies as part of transnational sectors, in Europe and beyond. And of course, FTSE International has an important role to play in all of this.

I would like to say something tonight about the growing significance of equity indices, both generically, and specifically in the European context. But perhaps I could begin by setting out, by way of background, the reasons why we at the Bank are interested in developments in equity markets.

The Bank of England has three overall policy objectives - or Core Purposes, as we term them - and developments in equity markets actually impinge on all three.

The Bank's first core purpose is the pursuit of monetary stability. Every month the nine members of the Monetary Policy Committee look closely at equity market developments and particularly at the level of the indices in the main markets. This is because, through confidence and wealth effects, changes in equity values affect consumption, and similarly, changes in equity markets imply changes in the cost of capital or investment opportunities and thus are an influence on investment behaviour. Additionally, equity markets may be able to provide useful information - ahead of the availability of official statistics - on the state of particular sectors of the economy.

The Bank's second core purpose is the pursuit of the overall stability of the financial system as a whole. This work has a number of different aspects - promoting structures and policies which enhance the robustness of the financial system; analysing prevailing financial stability conditions; and, in rare circumstances, crisis management work (which we carry out in conjunction with the Treasury and the FSA, as set out in the Memorandum of Understanding between us).

Finally, the Bank's third core purpose is to promote the competitiveness and efficiency of the UK's financial services, and that obviously includes the UK-based equity markets. In this area the Bank's role is very much one of raising issues and encouraging, and occasionally co-ordinating, the work of others, but not that of enforcing particular strategies or institutional changes. For instance, following the MMC investigation of sub-underwriting in equity markets, we are currently putting together a guide to good practice in that area.

So these three core purposes explain the Bank's range of interests in equity markets generally. In turning now to some of the issues raised specifically by equity indices, I would like to touch on two related issues. The first is the use of indices in benchmarking and more specifically the growth of overt tracker funds. The second is the role of indices, and the companies who publish them, in a competitive market place, especially within Europe.

There can be little doubt as to the significance of the use of stock indices as performance benchmarks - by both fund managers, and trustees. A substantial proportion of UK fund managers probably use one of the FTSE indices as a benchmark. In terms of direct asset allocation, it is now estimated that somewhere between 15 per cent and 20 percent of institutional UK equity assets are managed so as overtly to track one index or another. This is less than in the US - where the figure is reckoned to be around 35 per cent - but it is still a substantial amount of money, around £100 billion. Of these UK index tracking funds, a majority probably track the FTSE All-Share. But newer funds are increasingly tracking the FTSE-100, and indeed there are a whole range of stock indices which can be, and are, tracked.

We are obviously interested in the factors which are driving this shift towards index trading. One facilitating factor is technical - the increasing availability of relatively cheap but sophisticated IT systems means tracking funds can be run at comparatively low management cost. Another factor is that, as financial markets everywhere have become more actively researched and traded, some investors feel that markets have grown closer to the textbook efficient markets paradigm; and even if such investors do not know about perfect market and random walk theory, they know that it's tough to beat the index. On one estimate only a third of actively managed funds outperformed the FTSE All-Share last year, although I think such figures need to be treated with a great deal of caution; detailed analysis of returns over a very long period of time would be needed to draw any firm conclusions about relative performance.

Of course some commentators have raised concerns as to whether the rapid growth of passive index tracking funds has had a disturbing effect on equity markets. It has been argued that the presence of fewer active funds means that less research has been undertaken into individual stocks, and so individual stocks may be priced less efficiently as a result. Another argument is that the cost of capital for smaller companies outside the major indices may be adversely affected to the extent that they are cut off from access to tracker funds.

These are debates which the Bank will continue to follow with interest, although I think there is little hard evidence to date of any such "macro" distortions. If there were significant pricing anomalies, I am inclined to think that the active fund managers would eventually exploit them. There may indeed be some element of natural adjustment here between passive and active managers. My own view is that the more immediate issues raised by index tracking funds are more "micro" in nature, relating to issues such as the design of particular indices - for instance making sure the rules governing the composition of indices do not increase artificially the volatility of stocks entering and leaving the index.

Against this background of looking at design features I very much welcome FTSE International's current consultation paper. It raises a number of extremely important issues on which it is proper that there should be market consultation and a full debate.

The consultation paper makes clear that among the principles underlying the composition of indices should be those of transparency and predictability. I welcome this; these are important principles in terms of underpinning confidence in indices. Over the last couple of years those of us from the official sector have often proclaimed, in speeches such as this, the importance of transparency, so it is good to see an echo of this from the private sector.

The consultation paper covers the difficult issues of the size of free float, cross holdings and the issue of nationality. On the last issue, the paper proposes moving from a fairly specific rule as regards nationality to a more general one, which introduces a degree of discretion. This is one area where I hope and expect there will be a good deal of feedback from the market, since it is important that any new rules on nationality are consistent with the principles of predictability and transparency.

I have concentrated on transparency in the rules; but this carries over to governance issues as well. How the rules governing indices are devised and implemented clearly affects market behaviour. And this makes it important that there should be openness about process - about how committees are appointed; who serves on them; and how they reach their decisions.

So far I have focused mainly on indices as part of the investment process. But indices providers are of course also businesses in their own right, and indeed this is becoming an increasingly competitive sector. In European markets, for instance, as well as FTSE International, investors can choose from a variety of different indices providers. And of course only this week there has been a good deal of coverage of FTSE new "Stars" index. Competition between indices may become quite fierce, although I think it unlikely that a single dominant benchmark will emerge for some time. Fund managers, trustees and others may well want different indices for different purposes: some will prefer a narrow index, some a broad one; some will want a Euro area index only, whereas others will want a pan-European index, etc. So consultation about market needs is important in this context as well.

These competitive questions are also of course to some extent tied in with broader questions about the future development of Europe's equity markets; in particular as to how far and how quickly Europe moves towards having a single pan-European equity market, at least for its larger stocks.

Chairman I hope very much, indeed I am confident, that FTSE International will remain in the forefront of these changes. I hope there is a significant response to their consultative paper and I look forward to seeing the results of that process. But for now it remains only for me to thank you again for an excellent dinner and to congratulate the winners of the awards to be presented tonight.