

ESRB response to the ESMA Discussion paper on “Policy orientations and guidelines for UCITS exchange-traded funds and structured UCITS”

Introduction

International and European institutions and regulators are increasingly paying attention to Exchange-Traded Funds (ETF). The market for these investment products has experienced a dramatic growth over the last 10 years, and their increasing complexity poses risks to financial stability and investors' protection. Some recent developments of the market deserve further research for a better understanding. The ESRB welcomes the Discussion Paper on Policy orientations and guidelines for UCITS exchange - Traded Funds and structured UCITS -, which is a welcome reaction to the increasing opacity and complexity of a market which was originally composed of relatively straightforward financial instruments, and has now attracted the attention of several authorities¹. Developments in the UCITS exchange-traded funds market and the creation of more complex, opaque and sophisticated instruments, make the revision of the current regulatory regime appropriate. Structured ETFs are exposed to many risks and given their increasing popularity and market share, the ESRB considers that ETFs and structured UCITS should be analysed under a broader macro-prudential and financial stability point of view. The ESRB notes concerns expressed at a national level in member states and in major third countries jurisdictions², as well as in the international environment by multilateral organizations and institutions.

Systemic nature of developments in ETFs and UCITs

The ESRB stresses out the rapid growth of global ETFs in 2010 (Q3) when the total value of assets under management was \$ 1.2 trillion. US, European and Japanese equities constitute more than 50 per cent of global ETF exposures. In addition, the structured (leveraged and inverse) ETFs constituted around \$41 billion of ETF assets with exposures to US equities. (IMF 2011) Note that ETFs a consideration not just for retail investors but for other categories of investors – e.g. institutional. Furthermore, the disproportionately large size of some of the ETFs, compared to the market capitalisation of the underlying reference indices, raises concerns over potential disruptions in those markets due to heavy ETFs trading.

¹ See Financial Stability Board, Potential financial stability issues arising from recent trends in Exchange-Traded Funds, April 2011; BIS, Market Structures and Systemic Risks of exchange-traded funds, April 2011; IMF, Global Financial Stability Report, Durable Financial Stability Getting There from Here, April 2011

² In the US, the SEC announced in March 2010 that it is conducting a review to evaluate the use of derivatives by ETFs, and has therefore deferred consideration of new and pending requests for authorisation of ETFs that would make significant investment in derivatives.

The ESRB draws the attention of the European Securities Market Authority (ESMA) on a number of potential risks to the stability of the financial system stemming from developments in some segments of the ETF market. These include³:

- **Funding liquidity risk to swap counterparties:** The emergence of synthetic ETFs – where affiliated banks typically act as derivative counterparties to the funds – provide a direct link between the banking system and the ETF market. One of the key risks that banks, in their role as swap counterparties, are exposed to is funding liquidity risk. As part of a series of related transactions, swap counterparties receive cash and promise to deliver the returns of the index, posting securities as collateral to the ETF. Because the collateral does not need to match the assets of the index being tracked, banks might have incentives to use the synthetic ETF structure as a source of collateralised borrowing to fund illiquid portfolios. In times of stress, a withdrawal of investors from the ETF market might spill-over to a funding liquidity shock for swap counterparties. Similar concerns may rise for physical ETF using securities lending, when the collateral posted is not in cash and, especially, if counterparties are affiliated banks.
- **Counterparty credit risk and Securities lending practices:** The use of swaps or other derivatives by synthetic ETF structures leaves ETF providers and their investors exposed to counterparty credit risk. Although individual funds seek to mitigate this risk by requiring collateral from counterparties, collateral in itself can only partly protect against counterparty default. And, more broadly, the growth in swap-based ETFs increases inter-connectedness of the financial system as a whole – which might amplify shocks in times of stress. Physical ETF providers aim to replicate the returns of the underlying index by purchasing the basket of securities comprising the index– or an optimised subset of that basket. ETF providers can then generate additional returns through securities lending. This exposes funds (and ultimately investors) to counterparty risk. And, if securities are lent in exchange for cash which is reinvested in illiquid assets, the liquidity position of the ETF itself might be at risk. From a wider financial stability perspective, cash collateral that is re-invested in illiquid securities might increase concerns over the build-up of maturity mismatches across the financial system.
- **Market liquidity risk:** Investors are attracted to ETFs by their low transaction costs and apparent provision of on-demand liquidity. But there is a risk that, particularly during market stress, this liquidity may prove illusory, with end-investors and/or market makers unable to redeem their ETF holdings without materially affecting market prices. This risk might be increasing as ETFs increasingly reference less liquid underlying assets such as emerging market stocks, commodities and

³ The risks hereby mentioned are not exhaustive. Other potential risks which could be further examined are: “Leverage risk”: leveraged and inverse ETFs segments are one of the fastest-growing sectors of the ETFs industry, and exposures of these funds are currently concentrated in US and European equities and less so in emerging market securities. Risk of “market disruptions”: in the recent context of increasing commodity price volatility which have been partly attributed to the strong flows into commodities-based funds.

corporate bonds. The interaction of these trends in the ETF market with wider market developments, such as the growth in high-frequency trading, raises questions over the resilience of market liquidity during market disruptions/shocks.

- **Risk assessment difficulties:** Financial innovation is delivering ever-increasing complex strategies – leveraged ETFs, inverse ETFs, inverse-leveraged ETFs – which, combined with a lack of transparency and the involvement of many different actors and markets, complicate risk assessment for both investors and regulators alike.

Policy responses should be focused on targeted disclosure

The ESRB welcomes the suggestions proposed by ESMA on increased disclosure requirements. However, the ESRB is keen that lessons are drawn from previous experiences with the distribution of complex products:

- note extensive policies of disclosure in the past failed to address risks that built up and materialised in CDOs, ABS and other structured products.
- note that even where more sophisticated institutional investors held such products, risks were poorly understood.

The ESRB considers it appropriate that the ESMA would act in a pre-emptive way now to ensure the lessons from the recent crisis are applied to ETFs. The ESRB could suggest that the ESMA explore additional measures, from a macro-prudential perspective, to those proposed:

- **Need for formal cooperation between securities markets and banking sector regulators** to collect appropriate data, understand and monitor risks facing banks engaged in the ETF market. Specifically, the ESRB stress out the need of increasing further cooperation focused on funding liquidity risk and securities lending practices among the European Banking Authority and the European Securities Market Authority. This should contribute to better understanding of the system-wide impact of possible shocks that might propagate across banks and markets. Importantly, this includes the possible implications for banks' funding strategies in the event of future adverse shocks that might result in acute redemptions from the synthetic ETF market. For example, supervisors should seek to ensure that regulatory liquidity requirements fully account for the liquidity risk borne by banks acting as swap counterparties for ETFs.
- The proposal to **apply CESR's Guidelines on Risk Measurement** to collateral received as part of securities lending transactions is welcome. These guidelines require that 'non-cash collateral cannot be sold, re-invested or pledged' and that 'cash collateral can only be invested in risk-free assets'. Properly applied, these guidelines could reduce the risks associated with the build-up of maturity mismatches through securities lending activities discussed above. Moreover in order to reduce the risk of using ETFs as conduits for liquidity risk transfer by their counterparty, these guidelines should further mention that the liquidity of the

collateral should match the liquidity that can reasonably be expected from the assets of the index being tracked.

- **Disclosure should be further strengthened based on qualitative as well as quantitative criteria.** This may involve bringing regulatory standards closer in line with current best practices in industry. For example, disclosures to investors could be required at a higher frequency. And, for securities lending activities, examples of additional disclosures could be: the average/maximum percentage of securities on loans over a specified time period; the type of collateral held against securities lending; and the largest borrowers of securities.
- **Secondary market:** the liquidity provision and price formation processes of ETFs on secondary markets rely particularly on the implementation (most often by algorithmic and high-frequency traders) of liquidity provision and arbitrage strategies. Against the background of ETFs provision of ‘on demand’ liquidity to investors and questioning about the impact of HFT, concerns are expressed on the capacity of investors to assess truly available liquidity and related liquidity costs. Such concerns might affect in particular ETFs that track illiquid asset markets (such as emerging markets and commodities. They may however also occur due to specific ETF features such as the rebalancing of leveraged and inverse ETF positions. Thus, ETFs may be particularly vulnerable to liquidity shocks, and, due to their hybrid nature of stock and fund, particularly likely to transmit such shocks across markets, market segments and asset markets.
- **Regulatory arbitrage between financial products:** Similar disclosure requirements to investors should be required for financial products such as “Exchange Traded Products”, that show similar features as ETFs but are not structured as funds; **UCITS products should remain simple:** If further systemic risk analysis should conclude that additional measures are necessary and adequate, the ESRB encourages for additional standards to be developed , which might ultimately suggest that ETFs (and financial instruments with similar features) may only be sold as complex vehicles.
- **The possibility for the withdrawal of the UCITS label** for complex and opaque structures could be explored to ensure that UCITS products remain simple⁴.

The ESRB does not object to ESMA publishing the ESRB response to the ESMA Discussion Paper on Policy orientations and guidelines for UCITS exchange-traded funds and structured UCITS.

⁴ The implications of a possible withdrawal of the UCITS label from complex instruments including whether there would be a sufficient range of remaining instruments to meet UCITS requirements, merit attention.