

ICMA AMIC Response to Central Bank of Ireland Discussion Paper on ETFs

Introduction

The International Capital Market Association (ICMA) Asset Management and Investors Council ('AMIC') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus and both buy-side and sell-side representation. AMIC welcomes the opportunity to respond to this consultation by the Central Bank of Ireland (CBI) on its Discussion Paper on Exchange Traded Funds (ETFs).

AMIC has long taken an interest in the development of ETFs. In 2011 AMIC published a [short general paper on ETFs](#) with a description of different types of ETFs, the state of the ETF market, assessments of market trends in ETF development and usage, the future development of the ETF market and the value of the ETF brand.

More recently, AMIC's interest in ETFs is limited to their relevance to the debate on systemic risk. We have already been active in the global debate on the possible systemic risk related to asset managers. AMIC has responded to three FSB/IOSCO consultations on the topic, in [2014](#), [2015](#) and [2016](#). AMIC has also jointly with the European Fund and Asset Management Association (EFAMA) drafted a [research report](#) on liquidity risk management in investment funds and a [research report](#) on leverage in investment funds.

ICMA has also contributed to the debate on corporate bond market liquidity through extensive studies published in [2014](#) and [2016](#). On both occasions, we found that ETFs may contribute positively to corporate bond liquidity.

In light of these activities, we will restrict our response to the Discussion Paper to questions related to systemic risk and liquidity, in Sections II (Distinctive ETF risk factors), IV (ETFs and market liquidity) and V (Other considerations).

Section II: Distinctive ETF risk factors

General comment: Although frequently cited in the text, we do not believe that the ESMA 2012 Guidelines¹ are sufficiently taken into account by the CBI in their analysis and questions. Many of the issues that are raised by academic literature in the discussion paper are already addressed by the Guidelines and do not need further policy measures.

Furthermore the Guidelines focused on UCITS ETFs. It is therefore important to distinguish between UCITS ETFs and other types of exchange traded products such as ETN, ETIs and ETCs which, although exchange traded, have a different structure and are subject to different regulatory requirements.

G. Are conflicts of interest rules effective for dealing with concentrations of activities within an ETF provider's financial group (e.g. group entities could act as promoter, investment manager, AP and swap counterparty or SFT counterparty)? Are other approaches worthy of consideration?

¹ Guidelines on ETFs and other UCITS issues

https://www.esma.europa.eu/system/files_force/library/2015/11/esma-2014-0011-01-00_en_0.pdf

Yes, current rules in EU regulation and guidelines are effective at dealing with a provider's group concentration of activities.

Potential intra-group conflicts of interest between the ETF provider – typically, a UCITS management company – and other group entities are already addressed by the existing UCITS legislation. The latest amendments to the relevant directive (UCITS V) have clarified the principle of functional (and hierarchical) independence vs. structural independence between the UCITS management company and other group entities, especially with regard to the role of the depositary. Apart from the requirements of the UCITS management company to properly identify, manage, monitor and disclose potential conflicts of interest, there are other important and legitimate drivers to justify the opportunity for an ETF provider to rely on intra-group service providers, whether these be AP, lending agents, depositaries, fund administrators, etc.

Among these drivers, best execution in the interest of the ETF investors can justify choices in favour of arm's length transactions between separate entities within a same group. Typically, ETF providers issue Requests for Proposals (RFP) to multiple and non-affiliated service providers for services as depositaries and counterparties, as part of a public tender to attract bidders. The ultimate selection rests on a thorough and documented due diligence process undertaken by the ETF provider to ensure that the preferred service provider meets all of the required standards needed to support a specific ETF product, including expertise, infrastructure, IT systems, etc.

H. Are multiple counterparties necessary, or appropriate for ETFs? Could they expose ETFs to unintended risks and consequences?

Whilst we do not support regulating the number of counterparties, we do consider that there is value in disclosing counterparty arrangements, albeit at a high level, to end-investors. As already noted by the Central Bank of Ireland, EMIR contributes to risk reduction among counterparties to swaps, although in the case of the total return swaps of synthetic ETFs, initial margin only helps a few days.

I. Some academic research suggests that if a synthetic ETF experiences counterparty default, the synthetic ETF is more likely to be able to deliver the performance of its underlying index if the collateral received is correlated to that index. Should collateral received (where a funded model is used) or securities purchased (where an unfunded model is used) be correlated to the index being tracked? Is this practical, particularly for example where the index tracked by an ETF is comprised of securities which may be relatively expensive to access? Is collateral quality sufficiently regulated and disclosed?

We believe the existing requirements in the ESMA 2012 Guidelines on collateral quality are sufficient. The ESMA 2012 Guidelines require that, regardless of the replication structure, collateral (other than cash) received either by entering into OTC derivative transactions, or from efficient portfolio management techniques, should respond to a specific set of requirements. Moreover, for those ETFs relying on a synthetic replication model based on an OTC swap contract, the assets received by the UCITS as a “collateral basket” should be diversified and comply with the UCITS investment limits set out under Articles 52 to 56 of the UCITS directive.

With regard to the correlation between the collateral basket received and the components of the index being tracked, the purpose of collateral is to protect against default – hence the “high quality”

requirements under the ESMA 2012 Guidelines. Considerations around the appropriateness of correlating the composition of the collateral bashed with the index components are thus of secondary importance and risk de facto complicating the basket's liquidation were the ETF's counterparty to default.

Also, by introducing a strict correlation requirement, breaching the UCITS counterparty risk limits of 5% to 10% can become more likely. Moreover, it would introduce a needless distinction between the two main ETF replication methods addressed in the discussion paper, and possibly beyond (i.e. envisaging separate collateral requirements for ETFs vis-à-vis other UCITS). We therefore do not support any suggestion aiming to go beyond the scope of the current ESMA Guidelines.

Finally, requiring an unfunded model to purchase securities, or a funded model to receive collateral, that are correlated to the underlying index may not be practical in a number of scenarios. For example, this may not be practical for certain types of index constituents, e.g. commodities futures, and certain types of collateral may have much higher haircut requirements. In addition, it may be more practical and efficient for certain synthetic ETFs to hold or receive securities or collateral that have a lower liquidity risk.

Section IV: ETFs and market liquidity

General comment: We appreciate the thorough aggregation and analysis of academic literature into the effect of ETFs on market liquidity conditions in Section IV. We will take this into consideration in our future consideration or corporate bond market liquidity issues. We agree with the CBI that there is not necessarily any need to regulate any potential long-term negative effect on liquidity.

With regard to liquidity risk management for ETF structures, as the funds are UCITS funds, the same liquidity risk management tools and practices that are used by vanilla UCITS funds are also available to be used by ETF funds. We refer to our [report on investment funds liquidity risk management](#) for further details, although not all tools will be relevant for ETFs. ETFs will have additional liquidity risk management practices, befitting their structural differences with funds which are not traded on exchange.

L. Some commentators are concerned that ETFs are tracking indices of underlying stocks which are not sufficiently liquid to match the intra-day liquidity on the secondary market which the ETF offers. This statement is quite simplistic and does not, for example, reflect that there may be much secondary market activity but very little primary market activity. UCITS, including UCITS ETFs, are subject to general liquidity management rules which should ensure that ETFs track indices of underlying stocks that are sufficiently liquid to allow the ETF to meet creation and redemption requests. Is this sufficient? What liquidity practices do ETFs follow? Are there other practices that might be appropriate for ETFs?

The analysis does not sufficiently reflect that there may be significant secondary market activity but very little primary market activity.

Even before the launch of an ETF, adequate market liquidity in the underlying asset class is a key consideration. The liquidity of assets and the structuring and operational model of open-ended funds, including ETFs, should be assessed and reviewed as part of the fund approval and set-up process. This is the responsibility of the manager and should be discussed in conjunction with the trustee / depositary (where applicable) and regulator as part of the authorisation process.

The expertise and capabilities of the selected APs to trade the underlying basket is an essential part of the calibration of the ETF's size relative to the underlying liquidity conditions. The AP will have to hedge its exposure by trading the underlying securities, so market liquidity is carefully assessed and stress tested to ensure that creations and redemptions can comfortably be dealt with by the AP, including under abnormal conditions where large buy or sell imbalances in the secondary market may materialise.

After the launch of the product, the performance of the product is monitored alongside potential changes in a benchmark index, to ensure the ETF meets its investment objectives. However, considerations around the breadth and depth of the secondary market rest with the AP and other official liquidity providers (OLPs).

As recognised by the CBI, secondary market activity often strongly outpaces primary market trading of ETFs. This has the helpful effect that the broader and deeper the secondary market, the greater the ETF's shock-absorbing role is in the event of large order imbalances, leaving the underlying primary market and fund AuM unaffected.

M. One of the potential impacts from greater investment in index-tracking ETFs is decreased informational efficiency of underlying securities as well as increased non-fundamental volatility of underlying securities. However, these may not be risks per se or, at any rate, may not be risks that ETF providers or regulators can mitigate, manage or eliminate. Is this assessment correct or could measures be taken to address this impact?

We have taken great interest in the CBI analysis of the potential short-term and long-term effect on the liquidity on underlying securities of ETFs. We believe that the tentative conclusions that, over time, underlying securities may suffer from "decreased informational efficiency", or from "increased non-fundamental volatility", should be tested further. In particular, as noted by CBI in Section V, much of the academic literature focus on the US. It would be helpful to study this further in European conditions. While availability of data in European markets has in the past proved more challenging than in the US due to the fragmentation of European markets the forthcoming MiFID II transparency requirements should start the process of improving European Data Quality. We regret, nevertheless, the slow progress towards the development of a true European Consolidated Tape which would bring benefits to investors in assessing the liquidity of ETFs in European markets and to investors in terms of greater understanding of how market events may affect European ETF liquidity

Such further study should also include aspects outside the control (or influence) of the ETF, for instance, the motives behind the inclusion of certain securities into a given index and the impact this has on volatility. Such motives could very well reflect efficiency considerations tied to a company, region or country's good economic prospects (e.g. the recent decision by MSCI to include Chinese A-shares into its Emerging Markets Index).

It is important to also recognise that greater investment into shares of ETFs does not necessarily translate into creations and redemptions. As noted in our answer to Question L above, larger ETFs (including some in fixed income) are characterised by a secondary market with a depth many times the volumes exchanged on the underlying's cash market.

N. One of the key issues in the context of support by ETF providers is investor expectation. Investors' views about purchasing ETFs and their ability to sell may be informed by whether or not

the ETF provider will support the ETF in the face of stress events. There are, however, divergent views amongst ETF providers as to whether they would support their ETFs. Is provider support a desirable objective?

The notion of support in this question is not clear. ETF providers rarely rely on forms of liquidity support from an affiliated entity.

As for any investment fund, ETFs in Europe are typically authorised as UCITS products, complying with extensive investment risk disclosure requirements, stemming from the relevant UCITS directive and supplemented by the ESMA 2012 Guidelines. As a pure investment product, no forms of support, or implicit guarantees, should exist.

Section V: Other considerations

O. The Central Bank is primarily interested in risks associated with Irish authorised ETFs and European ETFs more generally yet much of the available academic literature, analysis and data relates to US ETFs. The concern is that any analysis of Irish authorised and European ETFs may be adversely affected by our reliance on US-centric materials. Is this valid? Are Stakeholders aware of EU ETF specific information that might lead to different conclusions? Will MiFID II resolve these data issues?

We think it is a valid concern that analysis of European ETFs could be adversely affected by reliance on US-centric material.

As already identified by the CBI, the fact that in Europe roughly 70% of all ETF volumes trade off-exchange (OTC) is a key difference to the US and is worth considering during the policy debate of ETFs. MiFID II is expected to bring more trading on-exchange from January 2018. Unlike in the US, current MiFID rules in Europe do not mandate ETF trade reporting (as ETFs are not MiFID instruments), with only about one third being reported and with ETF liquidity remaining fragmented between some 25 exchanges across Europe.

P. Does the nature of an ETF have peculiarities (and therefore risks) that neither the UCITS, nor MiFID regulatory frameworks, either in isolation or in conjunction, address and which has not been examined here?

We do not consider that there are risks unique to an ETF which are not already addressed by the UCITS and MiFID frameworks.

Most of the public and regulatory concern about ETFs, such as the alleged “liquidity illusion”, stem from a lack of understanding about the peculiar characteristics of ETFs, as opposed to traditional open-ended funds. The CBI’s Discussion Paper is a welcome addition to the debate.

There is insufficient understanding of the arbitrage mechanism underlying the ETF structure: the role of the AP needing to constantly manage its exposure whilst ensuring that the ETF share prices and the iNAV remain closely aligned.

There is also an insufficient focus on some of the short-comings of the market micro-structure around ETFs. These micro-structural issues can affect the pricing of underlying securities in volatile



trading conditions, which may in turn have a knock-on effect on the liquidity of an ETF's secondary market. Abnormal trading sessions, market closures, use of circuit-breakers, etc. have in some instances forced exchanges to temporarily suspend trading for certain ETFs. In other instances, ETFs could demonstrate value as a price discovery tool even when exchanges had halted trading in underlying securities. So, ETF suspensions often and more appropriately reflect possible flaws in the (micro) structure of exchanges, not risks inherent to the ETF product itself. There is also evident proof of price discovery by ETFs at time when a significant percentage of their underlying securities is not trading.

We would encourage the CBI to carefully take these episodes into account, suggesting there are more appropriate ways to address investor concerns without addressing the ETF product design into question via future policy actions.

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