Exchange Traded Funds: stability and growth - Remarks by Director General, Derville Rowland

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Remarks delivered by Director General, Derville Rowland to the Central Bank's Exchange Traded Funds Conference

Introduction

Good morning ladies and gentlemen. Welcome to the Central Bank of Ireland's Conference on Exchange Traded Funds. Given the topics on today's agenda, I know it will be an interesting and thought provoking day. Events such as these are essential for informing perspectives, challenging assumptions and developing new points of view. The importance of conferences such as this one for informing regulatory policy development cannot be underestimated. It is an opportunity for regulators to gain a deeper understanding of industry practice. And an opportunity for industry to better understand regulatory considerations. Nowhere is that more important than in the evolving world of ETFs.

Regulatory Initiatives – Global and Domestic

The attendance today speaks to the fact that ETFs present important issues for us to consider. Product innovations, such as ETFs, can bring benefits. In the case of ETFs, these include increasing market liquidity, diversification of risk and reducing costs for investors. However, innovation also brings with it a need to continuously assess potential risk. In particular, remembering the hard-learnt lessons of the financial crisis, we must be mindful to assess new market innovations through the prism of a risk centred approach. I know these themes will be debated at length during the course of the day.

This conference itself is timely given the growth in ETFs in recent years. This growth has been noted in the media and by ETF providers. ETFs are now presented as the structure of choice and there appears to be little sign of this abating. Regulators are therefore mindful of the expanding ETF footprint as a percentage of the global asset management industry. Indeed, it is an area of increased focus for European and international regulatory authorities alike. Both to better understand the advantages but also to understand potential risks of ETFs. In order to achieve this, it will be important for authorities to understand all of the relevant actors, their activities and interlinkages, both domestic and international.

These issues are important to the Central Bank of Ireland for a number of reasons. Ireland is a European hub for ETFs. There are currently 730 Irish authorised ETFs with more than EUR333 billion in assets under management. We are mindful of the European and global reach of Ireland's investment funds sector. Crucial to achieving our overarching mandate, to safeguard stability and protect consumers, is ensuring the effective supervision of Ireland's global funds industry.

With both domestic supervision and international policy development in mind, the Central Bank recently published a Discussion Paper on ETFs. This was intended to collate various ETF considerations, knit them together and present them in a single place. Many substantial replies have been received to this discussion paper. These are available on our website and will be subject to further consideration over the coming weeks and months. Let me return to this a little later.

Regulatory Framework

UCITS

Before turning to more specific matters, it is very important to recognise the robust regulatory framework in which ETFs operate. In particular, I would like to focus my remarks on UCITS ETFs. The UCITS Directive and relevant European Supervisory Market Authority's (ESMA) Guidelines provide significant regulatory protections. A core element of the UCITS framework is premised on liquidity. This is reflected in the ability of investors to deal with the UCITS on at least a twice monthly basis and, fundamentally, on the liquid nature of the fund's investments. Liquidity for UCITS is key.

A primary risk that has been identified with ETFs is that assets in which they invest may be relatively illiquid. Availability of liquidity at the underlying market level will then have a bearing on primary and secondary market levels. This might mean that underlying assets may not be as accessible and as a result liquidity may not be sustained. The extent to which liquidity can be sustained may be more pronounced for certain asset classes. For example, the high yield bond market. Questions in relation to resilience have been asked. We will most likely hear more on that point today. However, it is crucially important to recognise that the UCITS framework provides very substantial protections in relation to liquidity. Significant duties and obligations are placed on ETF providers in relation to assessments and sustainability of liquidity. It will be interesting to hear views on these issues today.

Let me now turn to the ESMA Guidelines for a moment. These guidelines provide the only architecture within which ETFs are specifically catered for. The guidelines require clear disclosure in a number of key areas, including the index used by the ETF and the anticipated tracking error under normal market conditions.

The ESMA Guidelines also envisage secondary market investors being in a position to redeem shares directly from the UCITS ETF in circumstances where the stock exchange value of the shares significantly varies from its net asset value. The associated complexities with this should be acknowledged and further investigated. Notwithstanding this, it is an important requirement. This issue was clearly set out in both the Discussion Paper and responses received by the Central Bank.

MiFID II

Turning now to MiFID II. Of significance from an ETF perspective is that ETFs have been brought into scope of best execution and cost transparency requirements. This is clearly important. The extensive pre and post trade transparency requirements will now be applicable to ETFs and the publication of pre and post trade transactions will provide an insight into ETF liquidity. While this is to be applauded, we recognise that the MiFID II requirement is on a per-trading venue basis. This therefore results in difficulties in understanding the overall depth of liquidity in specific ETFs (as data will not be available on a consolidated per-ETF basis).

Let me now return to the earlier theme of resilient liquidity. Of particular interest is the MiFID II requirement for trading venues to incentivise liquidity provision. Now that trading venues must incentivise official liquidity providers to maintain their presence in stressed market conditions, regulators will be watching the development of different models and how successful these are with interest.

ETF Discussion Paper

If I may, I now turn back to the Central Bank's Discussion Paper on ETFs and draw out some key themes that are being debated. First among these is an understanding of the risks potentially associated with the Authorised Participants (APs). ETFs rely on APs to deliver shares to market and to act as the channel by which shares are removed. As such, they are integral to the chain of supply to the market of ETFs.

The risk that the AP mechanism might fail to function may seem remote. Until now, it appears that market forces have addressed any faltering of the AP mechanism. The question is, will this always be the case? Will there always be an ability to rebalance the number of ETF shares in the market in a way that will address supply and demand issues?

We acknowledge that the secondary market liquidity which is underpinned by AP activity has many sources. Healthy levels of ETF liquidity can exist without any AP primary market trading. However, the question must be asked, what would the impact be of APs stepping away from the ETF, particularly in times of market stress. If an AP mechanism ceases to function, it is not clear what would happen. Much of the trading in an ETF does not involve the AP, so trading may continue as normal, at least for a time. But it may not. Trading volumes can display highly unpredictable levels of resilience to shock.

Of particular relevance is the impact on secondary market investors. When investors have purchased shares in an open-ended UCITS, albeit structured as an ETF, how are their concerns addressed? Will secondary market investors be left in the invidious position of having to bear the cost of widening spreads which are dissociated from the prevailing NAV? Or will they have no counterparty with which they can trade? Is this likely or fair? Is this the trade-off for purchasing in a fund that can be traded on an intra-day basis? All of these questions will need to be teased through over the coming months.

A further complicating factor could be the scenario where the AP architecture is not as open as otherwise thought. If an ETF issuer limits the permitted APs, what are the potential consequences? More limited competition is one. What impact would this have at times of market stress?

All this illustrates that the role and functioning of APs and secondary market liquidity is complex and deserves further reflection. As responsible regulators, we are tasked with understanding these questions and the impact of the answers.

When the ETF structure represents a small share of the market (some estimates are that only 8% of the global market is invested in ETFs), it makes sense to have a high tolerance for unlikely events. When ETFs are more important to the functioning of markets overall, perhaps there is a point where the appetite for tolerance is tested.

We will hear today how the use of ETFs is evolving. Increasingly ETFs appear to be used for liquidity purposes or what the market terms as liquidity sleeves and liquidity buckets. Perhaps this is more a feature of European markets where the majority of investors are institutional. That being said, what happens to those markets or those institutions if ETF trading falters?

Investor Protection

There are also some potential investor protection issues related to the structuring of ETFs. Some of these were explored in our Discussion Paper. The topic which has garnered most interest is in relation to ETF and non-ETF share classes in a single fund. ETF providers are anxious to avail of this structure. Market participants are not as enthusiastic. The ultimate question will be, does permitting this structure result in inequity?

This is somewhat akin to market participants becoming APs on a forward looking basis. By this I mean, they may become APs despite not intending to actively participate in either the primary or the secondary market at the point in which they become APs. There are two ways to look at this. The ETF may be permitting opportunism. The other, is that the ETF may be employing appropriate risk management. The ETF may be ensuring it has systems and procedures in place to replace an AP that falters. This feature is clearly not available to the retail investor. In an extreme case, this could result in retail investors being faced with the prospect of holding ETF shares that they cannot redeem. At the same time, there would be institutional investors who could redeem shares because they had signed up to be APs. However, such institutional investors may not have acted as APs previously.

These are very much open questions. I am sure they will be the subject of lively debate today.

The contribution industry has made to the Discussion Paper in the form of its responses cannot be understated. The responses have enabled us to challenge our views and our understanding on ETFs. The feedback will also enable the Central Bank to contribute meaningfully to international discourse on ETFs. In this context, cross-border coordination is of great importance. The Central Bank continues to work proactively alongside other authorities at various European and international bodies seeking to progress the topics which will be discussed here today. This includes involvement in the work of the Financial Stability Board, the European Systemic Risk Board and the International Organisation of Securities Commissions.

Coordination, common understanding of objectives and knowledge sharing have been central to developing a coherent supervisory framework both globally and throughout Europe.

We have also benefitted from the strong engagement with industry associations, such as Irish Funds, which has been integral to the development of our thinking as we implement a coherent supervisory framework.

Conclusion

With this in mind, I am delighted to open the conference today. During the proceedings, the current developments for ETFs will discussed, along with the challenges we face in fully understanding this particular market development. If I could instil one message here today, it would be that we wish to reinforce co-operation and knowledge sharing between jurisdictions. Supporting the development of a common, global, understanding of ETFs is very important.

Let me finish by welcoming all of our speakers, panellists and moderators. I would like to thank them for their participation. At this juncture, it is my pleasure to introduce you to our first keynote speaker, Mr Paul Andrews, the Secretary General of IOSCO.

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