ICMA
International Capital Market Association

ASSET MANAGEMENT AND INVESTORS COUNCIL

Financial Stability Board
Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

May 16, 2011

Sent by email

Dear Sirs,

Potential financial stability issues arising from recent trends in ETFs

The ICMA Asset Management and Investors Council ('AMIC' or 'the Council') 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 having both buy-side and sell-side representation.

The AMIC composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. The AMIC's focus is on issues which are of concerned to its broad membership, rather than having a specific product focus.

The AMIC welcomes the opportunity to respond to the FSB note entitled 'Potential financial stability issues arising from recent trends in Exchange-Traded Funds (ETFs)'. The AMIC set up following its December quarterly meeting a ETF working group to consider issues related to the evolution of the product.

The Council ETF working group supports the efforts by the Financial Stability Board, the Bank for International Settlements and the International Monetary Fund to increase understanding of ETFs and exchange-traded products, including notes, partnerships, grantor trusts, commodity pools and other non-fund structures.

INVESTORS USAGE OF ETFs

Investors' motivations for using ETFs have expanded and are no longer limited to cost advantage and broad market access concern. Although initially investors mainly used ETFs for managing asset allocation and increasing diversification (for which the simpler "early version" ETFs were entirely adequate), they are now seeking to use ETFs to take tactical positions, including negative positions in asset classes, either to remove existing unwanted exposure or to express a negative view. In all of this investors are utilising the essential characteristics of ETFs: their intra-day liquidity and enhanced flexibility, allowing investors to take both long and short positions. ETFs have been embraced because in a back-to-basics' environment, they provide transparency, simplicity, liquidity and other favourable features.

The increase in usage, breadth and product flexibility has driven a steady growth in the use of ETFs over the past decade. This expansion has been fuelled by the increase in the range of asset classes accessible through ETFs. Moreover, the introduction of ETFs covering emerging markets, commodities and property has allowed investors to access some of the performing asset classes of the past few years. On top of greater asset breadth, the range of instruments has also grown.

REGULATORY EXPECTATIONS

The AMIC ETF working group believes that it is important for investors to understand there are various forms of exchange traded products (ETPs) which tend to be loosely defined as 'ETFs'. The ETP industry needs to educate investors and be clearer on the labelling of various ETPs. The main areas of complexity and opacity relate to instruments often confused with ETFs - these are ETNs, ETCs and ETVs. In Europe, derivatives regulations are very well detailed and well established in the context of the UCITS directive. There is no such level of EU regulations concerning securities lending by UCITS.

In addition we support the FSB's view on the conflict of interests and risks associated with in-house products where the swap provider and ETF issuer are all a single part. ETF Securities is an independent product issuer supported by high quality counterparties which are regularly monitored with respect to their credit risk.

There is a concern about the practice of funds lending the securities in their portfolio to generate income that can be used to reduce the tracking error and/or to increase their own fee income. However the working group does not believe that the low charges of ETFs cannot be only explained by securities lending. Indeed income from lending equities has fallen since the financial crisis due to vastly suppressed demand to borrow, yet this has not led to a rise in ETF fund changes.

It is worth noting that the size of the over-the-counter (OTC) swaps used within ETFs is small compared to the overall size of the market. At the moment the non-vanilla segment of the ETF industry is probably not of sufficient scale to create any systemic risk. At the end of June 2010, according to the Bank for International Settlements, total forwards and swaps in equity linked derivatives amounted to $1,745bn, whereas the total size of assets under management in swap-based ETFs was only $124bn. All equity-linked exposures at the end of June 2010 totalled $6.3trn so again, as a proportion of this, European ETF swap exposure would be less than 2% of the total. European ETF swap exposure cannot easily be presented as a source of contagion and systemic risk when compared to the broader swap and OTC market.

The AMIC, and the ETF Working group. would be happy to discuss further with you the points made in this letter. The Secretary of the AMIC, Nathalie Aubry-Stacey, can be reached at Nathalie.aubry-stacey@icmagroup.org should you need further information.

Yours faithfully,

John Nugée
For the ICMA Asset Management and Investors Council