Comments on the FSB note of 12 April 2011 on Potential financial stability issues arising from recent trends in Exchange-Traded Funds (ETFs)

Dear Sir, Madam,

We are pleased to take up the invitation in your press release of 12 April 2011 to comment on the note you published on Potential financial stability issues arising from recent trends in exchange-traded funds (ETFs).

• Evolution of the ETF sector in the recent past
We agree in principle with you when you say in this note that the growth of ETFs is due to their many benefits from the perspective of investors, e.g. low-cost diversification, high liquidity and tradability, easy access to different markets. As a result, ETFs have become a particularly attractive investment vehicle in recent years (but it should be kept in mind that one reason for these strong growth figures is the low base they came from and that in absolute terms assets under management by ETFs are around 5% of mutual funds). A further benefit in the eyes of investors is their easy-to-understand performance, which is closely linked to a usually well-known index. Besides the diversification ETFs inherently offer, another plus is that active management of the funds invested is not necessary, which keeps costs low.

1) The Zentraler Kreditausschuss (ZKA) is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,200 banks.
• **Expansion of ETFs to different reference baskets/ ETFs using synthetic replication**

Driven mainly by investors’ wishes, ETFs have branched out to other reference baskets or indices to which they are linked. At the same time, ETFs using synthetic replication, which track the performance of the benchmark by using suitable derivatives instead of full replication, have emerged. Such an ETF may be superior to a fully replicating one. The tracking error can, for example, be kept much lower with derivatives than is possible with full replication. In addition, costly adjustment of the investment portfolio to the index can be avoided or outsourced to a business partner whose business model or market position enables him to handle this more efficiently. These ETFs are, moreover, much freer in the choice of benchmarks, allowing participation in a performance that would not be attainable through replicating structures. Besides different asset classes, such ETFs may offer exposure to markets that are otherwise difficult to access as they can leverage the infrastructure capacities of the swap provider (e.g. specific emerging markets).

It is important to highlight that ETFs using synthetic replication are regulated by the same set of rules in Europe, namely the UCITS rules, as further described below (e.g. ETFs are established as funds separated from the assets of the asset management company with a custodian).

• **Potential risks of ETFs**

As regards the potential risks, it should be noted that these are risks which may arise not only from ETFs but also from classical investment funds.

It should also be noted that ETFs are subject to the stringent provisions of investment law. This means that potential conflicts of interest are mitigated in the set-up of European investment funds. For example, it is a misperception that a bank can be both swap provider for an ETF as well as manager of an ETF as in the European market asset management and banking activities are clearly separated. European investment funds adhere to this principle by outsourcing certain functions (such as e.g. custody, administration, etc.) to third parties. The national legislation implementing the UCITS III provisions specifies the form in which collateral, e.g. to cover swap liabilities, is to be posted. In addition, collateral is assigned a haircut in practice, resulting in over-collateralisation. The collateral is separated and bankruptcy-remote. The ETF’s management company and the external depository monitor the quality and quantity of the collateral posted. If collateral is realised, this depository will safeguard the interests of shareholders, who are thus comprehensively protected.
Securities lending transactions create ETF-specific risk only to a limited extent (and irrespective of full replication or synthetic structures). The FSB itself points out that securities lending is customary among actively managed funds as well. Securities lending is also subject to the stringent provisions of investment law. This ensures that only liquid securities can be used as collateral. This collateral is realised if loaned securities cannot be redelivered in time.

The fact that many investors may return their investments at the same time, adversely affecting securities lending as well, is a general financial market phenomenon, so that liquidity squeezes and/or a drop in prices cannot be tied to a specific class of products.

A key promise of ETFs, also those whose underlyings are based on less liquid assets, is to provide constant, high liquidity for investors. This can often be achieved far better by synthetic structures. However, in stress phases investors may tend to first offload risky illiquid asset classes, which could make it difficult to keep the liquidity promise. Furthermore, ETFs using synthetic replication have the advantage that these risks can be transferred to an entity better endowed with expertise in such tasks, the reasons being that this entity regularly manages these kinds of risks or that it can reap economies of scale and scope because of additional or similar business.

• **Need to inform investors better instead of banning “harmful” innovation**

Not the FSB’s note, but the document published simultaneously by the Bank for International Settlements (BIS) “Market structures and systemic risks of exchange-traded funds”, compares the innovation in the ETF sector with the innovation in the securitisation markets which, in the US subprime housing market, was one of the causes of the financial crisis. While we agree in principle that mistakes like those made in the US subprime market must be avoided, we do not believe that braking innovation, which is, moreover, driven by customers’ wishes, is the right way to do so. Instead, (potential) investors should be enabled to make prudent investment decisions in line with their risk-bearing capacity. This can be achieved in two ways in particular – (a) by strengthening an understanding of financial mechanisms and (b) by providing the necessary information on the characteristics of financial instruments. The composition of many ETFs can already be viewed today on the internet. However, we agree with the FSB that there is still room for improvement on ETF transparency in some cases. ETF providers should (and often already do) inform investors about product composition and risk characteristics, as well as collateral baskets and arrangements for ETFs using synthetic
replication (positions in derivatives) and securities lending, to enable them to exercise due diligence.

Furthermore, we disagree with the position taken in the BIS paper that banks, as swap counterparties, co-mingle tracking-error risk with proprietary trading book risk and that replicating returns of broad market indices is not a core business of investment banking. Long before and independent of the nascence of ETFs using synthetic replication, (investment) banks accumulated expertise in these transactions.

Yours sincerely,
On behalf of the Zentraler Kreditausschuss
Bundesverband deutscher Banken

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