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Watchdogs probe systemic risks of passive fund growth

The growing weight of money committed to ETFs by asset managers is attracting more scrutiny, reports *Siobhan Riding*

Financial regulators across the world are increasingly focused on potential dangers of exchange traded funds, which now account for $5.2tn of assets globally.

The growth in ETFs has been encouraged by disenchantment at the high fees and poor performance of many traditional active managers that pick stocks and bonds with the aim of beating the market.

However, the scale of money now committed to these passive products has fuelled concerns that they may be storing up threats to consumers' interests and market stability in periods of high volatility or stress.

Events such as the flash crash of August 2015, when a large number of ETFs stopped trading in the US following wild stock market gyrations, served as a warning sign of the potential limits of the ETF.

Such episodes sparked a debate about the risks posed by ETFs, exemplified by Luis Aguilar, a former commissioner of the Securities and Exchange Commission, questioning whether regulators should "consider curtailing the growth of ETFs".

The debate has now worked its way on to the agendas of global securities regulators. Rory Tobin, global head of State Street Global Advisors' ETF business, says watchdogs want to ensure that "the next accident in financial services does not come from the ETF industry".

The US regulator fired the starting gun when it began a root-and-branch review of the ETF market in 2016. Ireland, Europe's largest ETF centre, with €362bn in assets under management, has followed suit.

Gerry Cross, director of policy and risk at the Central Bank of Ireland, the local regulator, says the probe reflected concerns that regulation had not kept pace with the evolution of the ETF industry. "It became apparent that there were emerging issues that warranted investigation, a lot of which came from product innovation and the resulting potential for increased complexity," says Mr Cross.

Ireland's review was primarily information-gathering rather than prescriptive. Mr Cross describes it as "a continuation of [the ETF] discussion" rather than its conclusion.

Ireland's move was significant, however, in laying the groundwork for an international regulatory push, co-ordinated by the Madrid-based International Organization of Securities Commissions. Iosco's work moves into full swing this year, examining investor protection and market integrity problems associated with ETFs. Together with the Financial Stability Board, which makes recommenda-

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tions to the G20 on financial rules, it will also look at whether ETFs could pose a broad risk to financial stability.

Richard Withers, European head of government relations at asset manager Vanguard, says 2019 could see more concrete action from policymakers aimed at minimising potential risks.

A core concern is ETFs' liquidity. Regulators are worried about the possibility of a failure in the market-making activity that underpins ETFs. The mechanism hinges on "authorised participants" (APs) — commonly investment banks — that buy ETF units at a discount to their underlying assets and sell them at a premium.

These players are not legally obliged to carry out this function, leading to fears that they may retreat in the event of a market crisis.

In such an outcome, investors may be forced to sell their ETFs at a discount to the value of their underlying assets. As the Central Bank of Ireland warned in last year, liquidity comes with a cost, and liquidity in stressed markets comes with an even greater one. The regulator questioned whether ETFs' reputation as a cheap investment solution is consistent with the idea that "an ETF could — or should — have a great tolerance for liquidity risk".

Asset managers play down the risk of a system failure, saying that the growth in ETFs, and the infrastructure supporting them, make the environment more robust. Manooj Mistry, co-head of index investing at DWS, says his company uses more than 30 market makers and APs. Five years ago, it had fewer than 10.

But regulators want to ensure investors benefit from more concrete guarantees that they can access their money in the event of a market rout.

The Central Bank of Ireland sees merit in rules stipulating that investors can circumvent market makers in the event of a system failure, allowing them to sell their shares at their true value.

Ireland also wants to be able to identify which organisations are serving as authorised participants and how they are remunerated in order to manage potential concentration risk. At present, the picture is opaque.

The other big topic for regulators is whether ETFs have the potential to exacerbate broader liquidity problems in securities markets. The concern is that if investors were to sell out of an ETF en masse, this could increase the chance of fire sales of the

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underlying security, which could affect financial stability.

Mr Cross at the Central Bank of Ireland says regulators need to examine whether ETFs investing in less liquid asset classes are increasing market fragility, by creating demand for assets that cannot easily be bought and sold.