

Derville Rowland: Past, present and future of Exchange Traded Funds

Remarks by Ms Derville Rowland, Deputy Governor of the Central Bank of Ireland, at the Vanguard / Arthur Cox event, "Exchange Traded Funds - Unlocking the Potential for Europe and Ireland", Dublin, 24 October 2024.

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Introduction

Good morning. Thank you to Vanguard and Arthur Cox for the opportunity to speak at this event and join the discussion on the potential of Exchange Traded Funds (ETFs).¹

In preparing for these remarks, I recalled a speech I made in 2017 on the topic of ETFs.² This was at a conference organised by my colleagues and I at the Central Bank. At that time, while the growth in the Irish ETF sector showed no sign of abating, I doubt many predicted just how strong the sector's development would be.

Today's event is timely with the Government's publication of its Funds Review Report earlier this week. My colleagues and I are supportive of this work and the recommendations made. The report correctly identifies the strong reputation that Ireland has built as a stable and well-regulated global financial centre. We look forward to working with the Department on the implementation of these and I will come back to that a little bit later.

In my remarks, I want to address three distinct areas – the past, the present and the future of ETFs. Throughout the course of this morning's event, we will hear about (1) *unlocking the potential of ETFs for Europe* and (2) *how we can foster growth in the Irish domestic investment market*. So let us first look back at where we have come from.

Past

Over the last three decades, Ireland has become a significant funds domicile and a key global centre for financial services. Since authorising the first European ETF in 2000, Ireland has firmly established itself as the jurisdiction of choice for ETF providers in Europe - with about 70% of the EU's ETFs domiciled here by Assets under Management (AUM).³

To put this in some context, AUM in Irish ETFs has grown from €162bn in 2014 to around €1.45tn this year. However, growth should not just be viewed in terms of AUM. It can be seen in the highly advanced ETF ecosystem which has developed in Ireland – across activities such as product development, administration, custody, legal, tax, accounting and auditing.

When we look at the range of Irish ETFs available, we can also see how it has evolved over the years. As you know the strategies which can be delivered through an ETF offering is impressively wide being subject only to the important safeguard of the UCITS requirements. Over time, we have seen the trends in ETFs seeking authorisation change considerably. These have moved from being simple market cap weighted index

tracking ETFs to a full complement of strategies – a lot of them index based which reflect investor needs. Ranging from so-called "smart beta" ETFs, to thematic, to ETFs delivering volatility or commodity exposure. We have also seen other ETF products often tailored towards the latest topic of focus.

Present

Today, a prevailing trend is the rise in actively managed ETFs seeking authorisation. Some factors behind this include ease of access for investors, investor demand for targeted active strategies, fee compression and the ability to capitalise on existing scale by the creation of an ETF share class to facilitate an additional distribution strategy. We are seeing ETF providers continuing to adapt to changing demands and a changing environment to serve investor needs.

As a regulator, the Central Bank must also be cognisant of the changing environment that we all operate in. I am aware that portfolio transparency is an important issue that has been raised by industry, particularly in relation to active ETFs and for further innovation in the sector. While this is still a relatively small part of the market, we note the increasing interest in Europe in these products. As a leader in Europe for ETFs, the Central Bank is open to engaging with industry to develop a proportionate and effective approach to different models of portfolio transparency in our domestic framework. We are likely to settle on a principles based approach rather than focusing on one particular model.

Another topic that garnered interest recently is the move of US securities settlement to T+1. In the lead up to implementation of the new settlement requirement, which became effective on 28 May 2024, there was much discussion about its potential impact on ETFs. This was particularly focused on UCITS cash and borrowing limit breaches. There was engagement on the topic at both an EU and local level. Locally, we engaged with industry to ascertain preparedness for the new settlement cycle and to inform our view on potential impacts or risks. We saw that much of industry is preparing for this change and that T+1 is already a feature of many primary market settlement cycles. This would go some way to explaining why, in the wake of the new settlement cycle, we have not seen a significant uptick in terms of T+1 related breaches in UCITS. However, anecdotally, we understand short-term trends have emerged with regard to an increase in funding gap costs. Nevertheless, the timeframe since the change of settlement cycle was introduced has been short. So we cannot say at this point if this is reflective of a medium- or long-term trend. We will continue to monitor developments.

Shortened settlement cycles for EU securities are also being pursued at a European level. The Joint Statement by ESMA, the European Commission and the ECB on 15 October⁴ outlined preliminary findings that will be delivered to the European Parliament and Council in the coming months. That statement urged the acceleration of technical work to support the move to T+1 and outlined the forthcoming publication of the governance structure which will oversee this work. It will be enormously important in light of the interconnected nature of our markets to achieve a harmonised approach across the entirety of the European trading ecosystem.

Moving to our domestic work, we have recently performed a review of the oversight that Fund Management Companies perform on key players within the ETF ecosystem. This

work was consistent with the IMF's recommendation to the Central Bank in its recent FSAP. Our work looked in detail at Authorised Participants (APs) and Contracted Market Makers. The review has identified a number of good practices in this regard as well as some areas for improvement. These include due diligence, ongoing monitoring and stress testing performed by management companies. We also found a lack of board reporting concerning the activities of these firms. The review also identified potential reliance and concentration on a small number of APs and contracted market makers. An industry communication will be issued shortly and this will provide further details on the findings. Suffice to say that more engagement from Fund Management Companies in this area would be helpful.

One other area of domestic work I would call out relates to ETF naming requirements. No, I am not talking about the ESMA Guidelines on fund names using ESG or sustainability related terms. Though, those Guidelines will certainly have an impact on the sector and Central Bank staff are currently working through implementation considerations. Instead, what I am referring to is the long-standing matter of how the UCITS ETF identifier is addressed in the Irish regulatory framework. We have listened to industry feedback on this point and engaged extensively at a European level in relation to it. As a result, we will be converging our approach with other fund domiciles and will shortly update our UCITS Q&As to clarify the position. In future, the UCITS ETF identifier can be included at the level of a sub-fund or a share class. This will provide greater clarity for fund managers and investors, particularly where the fund has both listed and unlisted share classes.

Future

Let me now turn to the future of ETFs. I would like to discuss how technology will factor into the development of the sector and how retail investment can be better harnessed in Europe.

It is clear that technology will continue to be a big driver of change for the ETF sector. As technological advances are made, we should see the ETF ecosystem become more efficient. For example, tokenisation is something which has the potential to speed up settlement cycles and increase efficiency and liquidity of trading in assets. In addition to this, there are potential benefits to investors in terms of ease of access to financial products and lower costs. At the Central Bank, we are supportive of understanding how tokenisation and related technology can bring benefits to both firms and investors. At an international level, engagement is ongoing with policy makers to assess financial asset tokenisation and its associated risks and challenges. We have engaged with the funds industry to explore pathways and the potential of tokenisation for investment funds, in particular to understand how tokenisation will sit within the existing regulatory framework. We look forward to continued engagement with industry on this topic as the sector and the technology evolves. Collaboration between industry and policy makers will be essential to moving this forward.

Advances in digitalisation will also lead to efficiencies and benefits for firms and investors. One of the benefits is that it allows easier access for investors to financial products, in particular retail investors. We have seen a rapid evolution in terms of distribution methods. This opens up possibilities both for managers and for retail investors. Managers are gaining access to new target markets, while investors benefit

from a multitude of different investment options. Any one of us can use our mobile phones to gain immediate access to a large range of different asset classes. And while we acknowledge that there are many benefits to easier retail investment access, it is not without its risks and challenges. We must consider and keep pace with the evolving manner in which retail investments are marketed, how information is disclosed and how products are being sold. We must also be mindful of the competition from easily accessible but unregulated products, such as Bitcoin.

Empowering retail investors and increasing their participation in capital markets is important for their financial wellbeing, as well as to support the wider European economy. Therefore, consumers need to see the benefits of investing in regulated products. ESMA's position paper on building more effective and attractive capital markets in the EU recognised that simple, cost-efficient, investment options are crucial for empowering citizens to invest their savings in capital markets that serve their long-term needs.⁵ UCITS ETFs – and Ireland's ETF sector in particular - has an important role to play in this regard.

The Europe Commission's Retail Investment Package highlighted many of the problems facing retail investors; for example, their struggle to access relevant, comparable and easily understandable information to make informed investment choices, issues around value for money in investment products, and challenges around financial advice. The consequences of this is that only 17% of EU household assets were held in financial securities in 2021, which is well below US households.⁶ We also know that according to ESMA's costs and performance report, retail investors in the EU pay higher fees – in the region of 40% higher - when compared to institutional investors. Simple, cost-efficient, products like ETFs have an important role to play in closing this gap and making suitable investment options more accessible to retail investors.

The Department of Finance's Funds Sector 2030 Report outlines analysis by the Central Bank which indicates that direct take-up of ETFs by Irish retail investors is low. In 2015, households accounted for less than 5% of total Irish resident's holdings of ETFs and this figure had fallen to less than 3% by 2019.⁷ As the Report notes, during the public consultation, the tax treatment of ETFs was identified as the main barrier to investment for Irish investors. The Central Bank is strongly supportive of the Review Team's recommendation that the taxation of ETFs is brought into closer alignment with the taxation of other savings and investment products. We know that in some countries, ETFs are being utilised as regular savings schemes and offer a practical mechanism for retail investors to access capital markets. With the right incentives, ETFs offer a practical means to move Irish customers away from high levels of dependence on household savings often held in bank deposits to more productive use of their finances. This in turn will support their overall financial wellbeing.

We must also do more in terms of financial literacy. At a recent National Financial Literacy Strategy stakeholder event, I spoke about the importance of financial education and how a well-rounded National Strategy will make a significant difference to citizens in terms of being more financially confident and secure. One of the measures we have implemented at the Central Bank is around the operation of our online Consumer Hub,

where we have published plain language explainers and videos to inform and educate consumers. We have more to do this in regard, but we hope that the Consumer Hub is a useful source of information and will build on this over time.

To understand these issues in more detail, the Central Bank will be undertaking analysis and research on retail market participation in Ireland. This will involve a targeted, large scale, consumer survey of investors and non-investors to gain a clearer understanding of key drivers and barriers to retail investor participation. We hope that this analysis and consumer research will also inform other policy makers in developing approaches to increasing participation levels in appropriate investment products which can help consumers grow their wealth over time, thereby contributing to their financial well-being. Our research will explore important attitudinal and behavioural factors that may impact investment participation. It will also look at factors such as the role of financial literacy, trust in financial institutions and the information provided to consumers.

Conclusion

As a leading, well regulated, funds jurisdiction in Europe, the sector has an important role to play in supporting the EU's Savings & Investments Union, and linking savers to the real economy, funding investment opportunities and providing an important source of finance for business. The financial services sector has a very important role in ensuring that consumers are provided with the tools, insights and options to make the best financial decisions for themselves. In Ireland, we need to highlight to consumers the benefits of investing in regulated products to better secure their financial future. ETFs and other investment funds can play a role in this, but we need to remove barriers to entry, put the right structures in place, and inform consumers of investment opportunities in order to increase retail participation.

As I noted earlier, Irish ETFs have grown significantly over the past decade. It is a success story for the jurisdiction and reflects well on the sector and on the importance of a robust regulatory environment that offers certainty and stability. It will no doubt be interesting to see what path the sector follows over the coming years and how the development continues to unfold.

Thank you.

¹ With thanks to Alan Bonny, Catharine Dwyer, Jonathan Dent, Michael Hennigan, Brendan Beere, John Rowe, Fionnghuala O'Sullivan, Giuseppe Insalaco and James O'Sullivan for their help preparing these remarks.

² *Exchange Traded Funds: stability and growth* - Remarks by Director General, Derville Rowland, dated 29 November 2017.

³ By assets under management.

⁴ Available at: https://www.esma.europa.eu/sites/default/files/2024-10/ESMA74-2119945925-2085_EC-ECB-ESMA_High_level_joint_statement_T_1.pdf

⁵ Available at: https://www.esma.europa.eu/sites/default/files/2024-05/ESMA24-450544452-2130_Position_paper_Building_more_effective_and_attractive_capital_markets_in_the_E

⁶ *Questions and answers on the Retail Investment Package*, European Commission, May 2023.

⁷ Central Bank of Ireland *Behind the Data: Exchange Traded Funds Held by Households: A Securities Holdings Perspective* (2020)