The Importance of Market Makers in the ETF Industry

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FLOW TRADERS

Introduction

In the Financial System Stability Assessment of Ireland, the International Monetary Fund (IMF) concludes that market makers play an essential role in the Irish ETF industry. The subsequent report by the IMF highlights the importance of two prominent market makers, one of which is Flow Traders, and the dependence on them to provide liquidity in the market. These two market makers represent around ninety percent of certain Authorized Participant (AP) activity for sixty percent of all European ETFs domiciled in Ireland.

The IMF's report poses that the role of these two market makers is too significant and therefore considers the situation a concentration risk. Consequently, the IMF has called for action by the Central Bank of Ireland to increase regulatory engagement with ETF providers. At Flow Traders we believe that key components that have led to the two market makers becoming most prominent have not been taken into consideration as part of this report.

In our view, the IMF has not considered why these two market makers have created a leading role in the industry. This is a consequence of the global scale that these two market makers bring, as well as their efficiency, superior price execution and their specialization within the field. Even though the two market makers play a significant role, this does not mean that other participants are not active in the industry. A combination of the specialization these two market makers bring and the multitude of other market participants has been overlooked in the report. We believe these factors lead to a more economical Irish ETF industry which benefits the end investor.

As one of the two leading market makers as outlined in the IMF report, we find it important that all aspects are considered and we believe the report as it stands has not taken this all into account. The report has a local focus, while the recommendations have a much wider impact than only for Irish supervisors. This leads to, in our opinion, an unnecessary increase of scrutiny on the entire industry. If the IMF is calling for action by the Central Bank of Ireland, we believe that the missing key components should be explored.

Flow Traders' Response

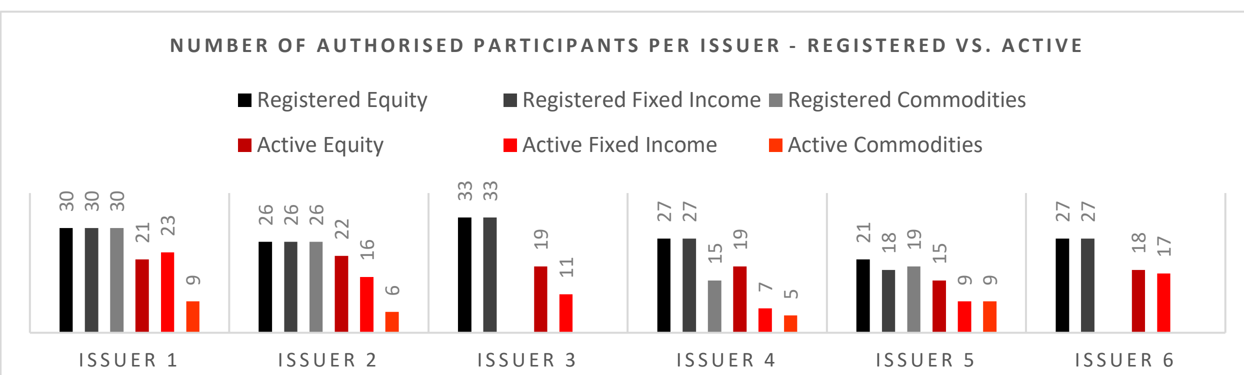
In 2022, the IMF published their Financial System Stability Assessment of Ireland.[1] In the subsequent report they outline that the Irish ETF industry has seen significant growth in recent years.[2] Ireland is now the domicile of around 60 percent of European ETFs by Assets Under Management (AUM), which is more than double compared to 2017. For the creation and redemption process, in which an ETF is created and redeemed by APs, the IMF reports that for certain ETFs ninety percent of the process is performed by only two APs, one of which is Flow Traders.

According to the IMF this creates a concentration risk: 'Only APs have direct access to the ETF for the purpose of creation and redemption activity, while market makers could choose to step away for providing liquidity.' Further in the report, the IMF notes: 'With respect to APs, two of the most active APs are responsible for up to 90 percent of AP activity for certain ETFs'. Despite this concentration risk and although market makers would be able to leave the market in times of stress, they actually remain in the market and continue to provide liquidity while other market participants can unnoticedly leave. The IMF and the International Organization of Securities Commissions have recognized this uninterrupted liquidity provision in their analysis of the 2020 COVID turmoil in the financial markets, when there was unprecedented volatility.

Following the assessment, the IMF has made the following recommendation: 'The relevant Central Bank supervision teams should engage with ETF providers to ensure their arrangements with APs and market makers are robust and promote the smooth functioning of the sector, including in times of market stress. There should also be closer cooperation between supervisors of Investment Firms and the colleagues supervising APs and market makers.' At Flow Traders we could not agree more that agreements with ETF issuers need to be robust and should promote the smooth functioning of the industry, especially in times of market stress.

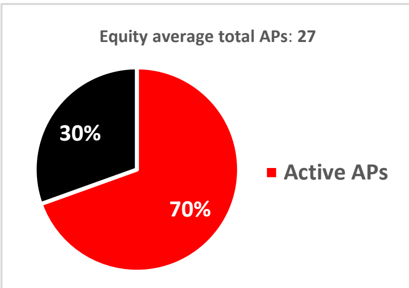
Flow Traders has always continued to provide liquidity, even during the market instability of the last decade. We do so by not only performing creation and redemption activity, but by also continuously quoting bid and ask prices on numerous exchanges and 'over-the-counter' globally. Through this approach, we redistribute risk, and keep investments and capital available for all market participants.

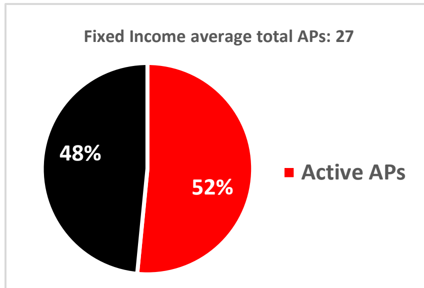
If a limited number of market makers would indeed make up for a large part of the European ETF market, which is mainly domiciled in Ireland, Flow Traders could understand why the IMF concludes a potential concentration risk. However, contrary to what the IMF suggests in their report, there is much more competition in the ETF industry. The following chart illustrates how many APs are registered globally with the largest ETF issuers. This chart indicates that the entire ETF industry is very much an open system and that if for example, a leading AP would fall out, there are more than enough other APs present to cover.

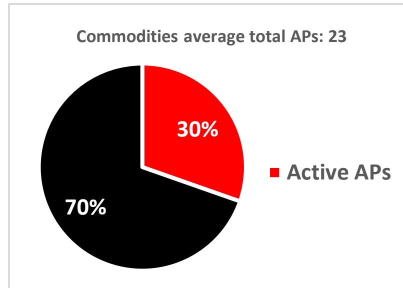


[1] Ireland - Financial System Stability Assessment, IMF Country Report No. 22/215, International Monetary Fund, Washington D.C., July 27, 2022.
[2] Ireland - Financial Sector Assessment Program - Technical Note on Oversight of Market-Based Finance: Investment Funds and Special Purpose Vehicles, IMF Country Report No. 22/242, International Monetary Fund, Washington D.C., July 27, 2022.

The below charts show the average AP activity per asset class. In equity (70%) and fixed income (52%) the activity is relatively high, whereas in commodities (30%) the activity rate is significantly lower. In Europe there are less commodity ETFs with less AUM traded in smaller volumes which could make it less attractive for APs to create and redeem.[3] Funds with more AUM typically have higher trading volumes and tend to be supported by more APs.[4] Nevertheless, on average seven APs are still active in the commodities space, which should account for enough competition. Put altogether, this data does not show there is large concentration within the ETF ecosystem. And a recent announcement of one of the biggest ETF issuers shows even additional increase of competition in Ireland.[5]







It is worth mentioning that the IMF in a previous report stated that ETFs are very liquid.[6] Short-term liquidity traders are more attracted through the provision of intraday liquidity. This emphasizes the fact that ETFs are at least as liquid, and more often even more liquid than its underlying. This contradicts the concentration risk that the IMF shares in their report, as more market participants trade very liquid instruments, leading to increased competition.

Finally, we believe it is unfortunate the report has such a narrow and local focus. According to the report, the goal of a Financial Sector Assessment Program is twofold. Firstly to gauge the financial sector's stability and secondly to gauge its potential to grow and develop. European Supervisory Authorities like the European Securities and Markets Authority, as well as the European Banking Authority already assess these goals comprehensively. They have concluded that there is no concentration risk within the Irish ETF industry. To avoid any panic regarding systemic risk, we would therefore recommend the IMF to in the future also consider the international element when performing a country assessment and to not invoke extra scrutiny on a heavily regulated and extremely competitive industry.

[3] justetf.com.
[4] iShares Investigates: The ETF Ecosystem - Part 2 | Authorized Participants by the Numbers, Merwin, Adiraju & Woodworth, iShares by Blackrock, 2022.
[5] Amundi steps up efforts to compete with BlackRock's ETF empire', Financial Times, Ed Moisson, 21 October 2022.
[6] Chapter 3 - Asset Price Fragility in Times of Stress: The Role of Open-End Investment Funds, International Monetary Fund, Washington D.C., October 2022.