European Banking Authority

European System of Financial Supervision

Financial Innovation and Consumer Protection

An overview of the objectives and work of the EBA's Standing Committee on Financial Innovation (SCFI) in 2011-2012

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Contents

I. Background and objectives

1. The regulation establishing the European Banking Authority (EBA) requires the establishment of a Committee on Financial Innovation (article 9). The main objective of the EBA's Standing Committee on Financial Innovation (SCFI), which was established in May 2011, is assisting the EBA in fulfilling its mandate in the areas of financial innovation and consumer protection, as described in article 9 EBA regulation, and more in particular to:

   a. Promote transparency, simplicity and fairness in the market for consumer financial products or services across the internal market, including by: collecting, analysing and reporting on consumer trends, reviewing and coordinating financial literacy and education initiatives by the competent authorities, developing training standards for the industry, and contributing to the development of common disclosure rules;

   b. Monitor new and existing financial activities (and potential for adopting guidelines and recommendations) with a view to promoting the safety and soundness of markets and convergence of regulatory practice;

   c. Safeguard the objectives of article 1(5) EBA regulation as against innovative practices and activities and achieving a coordinated approach to the regulatory and supervisory treatment of new or innovative financial activities; and

   e. Develop common methodologies for assessing the effect of product characteristics and distribution processes on the financial position of institutions and on consumer protection (article 8(2)(i) EBA Regulation).

2. Article 9(4) of the Regulations establishing the three European Supervisory Authorities (EBA, EIOPA and ESMA, collectively 'ESAs') is identical for the Committees on Financial Innovation of all three of them. It, therefore, does not clarify the different focus that each Committee has. However, it specifies that the Committees form an integral part of the Authorities and therefore the Committees' responsibilities must be examined within the scope of the Authorities' mandates. In other words,the respective ESAs' competence is defined in relation to the financial entities (institutions) they are mandated to supervise, which for EBA can be generically summarised as risks for – or originated by - credit institutions, financial conglomerates, investment firms (in relation to capital requirements), payment institutions, and e-money institutions.

3. However, the risk of overlaps or gaps between the three ESAs remains, underlining the need for close co-operation among theESAs - and also with the European Commission - both bilaterally and through the Joint

Committee’s Sub-Committee on Consumer Protection and Financial Innovation.

4. Instead of creating overlaps with other EBA committees, SCFI (with its two subgroups on Consumer Protection -SGCP- and Innovative Products -SGIP) aims to create synergies with other EBA work, e.g. by identifying and assessing risks which can be subsequently dealt with in other specialised EBA groups if deemed appropriate, i.e. SCRePol (EBA’s Standing Committee on Regulation and Policy) when regulation or guidance is recommended, and SCOP (EBA’s Standing Committee on Oversight and Practices) when supervisory action or convergence is recommended, and also by feeding into EBA’s wider assessment of risks and vulnerabilities in the European banking sector.

5. From 2012 onwards, the EBA will publish a yearly report, prepared by the SCFI, identifying areas of concern in both the consumer protection and financial innovation areas of the banking sector, as well as areas where these two intersect. This will include recommendations to EBA’s Board of Supervisors (e.g. for EBA to do further work or to take corrective or restrictive action), to national supervisory authorities (e.g. to further examine or address an issue locally), or to the Commission (e.g. for regulation).

6. The text that follows is organised in accordance with the SCFI mandate, i.e. section II covers consumer protection issues (further elaborated in Annex 1), while section III covers matters more closely related to financial innovation (and further details are provided in Annex 2 in relation to one innovative product, Exchange Traded Funds –ETFs).

II. Consumer Protection

7. Consumer protection requirements or conduct of business rules are designed primarily to ensure firms treat their customers fairly. This supports consumers' trust and confidence in retail financial markets and, as such, directly contributes to the latter's stability. The imposition of conduct of business rules aims to address a number of broad areas including:

- information asymmetry in the market, i.e. the factthat firms have more information and experience than the consumers they deal with;
- disclosure and transparency to ensure consumers are provided with information on the costs, risks and benefits of the products they buy and are able to compare products;
- fact finding so the firm understands the customers’ needs, objectives and circumstances;
- suitability so the firm sells a product which meets the needs, objectives and circumstances of the customer;

- follow up service or information, for example to inform the customer of changes in the price of, or any other terms attaching to, the product;
- complaints handling and/or redress processes, either to the firm itself, or, in many cases, to an alternative dispute resolution mechanism.

8. In addition, conduct of business rules may address other specific areas such as the speed of payment and settlement (in the Payment Services Directive) or the handling of mortgage arrears (where domestic rules are imposed by some competent authorities).

9. These rules are imposed to address potential consumer detriment and so the emphasis in developing consumer protection is on the risks to the customers rather than to the firms *per se*. However, it is clear that if a firm engaged in practices which caused significant detriment to its customers, this could ultimately cause significant problems for the firm, e.g., through having to repay money from overcharging cases, having to pay compensation for unfair practices, reputational damage following a sanction by a competent authority or being named by an independent ombudsman for poor practices. Given these risks, it is clear that conduct of business requirements enhance consumers' trust in financial services and enhance market discipline.

10. Annex 1 contains a summary of the outcomes of a first survey of national competent authorities, undertaken by the EBA, aimed at the identification of key issues with regard to consumer protection in the banking sector. Over the coming years, the EBA will enhance its analysis of consumer protection issues and use this analysis to develop its priorities and work program.

11. Based on the outcomes of the survey, the EBA decided to focus its work in 2012 on the analysis of the widespread concerns about consumer detriment in the context of the mortgage market and other indebtedness issues, including aspects such as advice, provisions, credit intermediation, credit cards, transparency, financial education, and complaints handling. The analysis of the above matters could potentially lead to EBA guidance or recommendations, where appropriate.

12. In addition, the EBA plans to organise a 'Roundtable on Consumer Protection' at which the EBA can outline its consumer protection strategy and plans, and seek input from stakeholders.

III. Innovative Products

13. EBA's mandate in the areas of financial innovation and consumer protection, as described in article 9 EBA regulation emphasises, but is clearly not limited to, issues from a consumer protection perspective; the mandate

explicitly includes financial innovations that might potentially be harmful for credit institutions, or the banking system and financial markets as a whole.

14. In the aftermath of the financial crisis which erupted in 2007 and amidst the current EU sovereign crisis, in combination with the necessary tightening of regulatory requirements being implemented over the coming years, there is reason for supervisory concern about a new 'search for yield', leading to yet unknown – and possibly insufficiently regulated - financial innovations, with potential risk for financial markets, the banking system as a whole, individual credit institutions, and – last but not least - consumers.

15. The EBA shall therefore:

    - aim at identifying potentially harmful financial innovations;
    - analyse such innovative products indepth, and assess the risks they raise;
    - take (or recommend) further action if deemed necessary.

16. EBA aims at setting up and continuing to strengthen this risk identification (or 'market intelligence') function with regard to financial innovation. It shall aim to do so partly by surveying - and conversing with – Member States' supervisory authorities, and partly by actively engaging with market participants, such as investment banks, structured finance lawyers and consultants, and retail and professional investors.

17. A first survey amongst Member States' supervisory authorities identified a number of products on which the EBA, and more specifically its SCFI, will do further work in 2012, such as collateralised commercial paper, contracts for difference, and convertible bonds. It has to be emphasized though, that given the preliminary nature of the SCFI's work in 2011, the above list should by no means be considered (nor is it intended) to be a comprehensive list of innovative and potentially harmful products in the EU banking sector.

18. Some preliminary work was also done with regard to the asset encumbrance of covered bonds and other types of secured funding, and this topic will be taken forward by a new subgroup of the Advisory Technical Committee of the ESRB. More in-depth work has been done by SCFI with regard to the so-called exchange traded funds (ETFs), as this is a rapidly growing market, both in terms of size and complexity (and hence a lack of transparency). Annex 2 provides an analysis of the market, the different structures of both physical and synthetic ETFs, and the related risks and supervisory concerns.

19. Identifying harmful financial innovations before their risks and adverse impact materialise is a difficult task. Traditionally, also given the inherently scarce resources, most supervisory work focuses on dealing with visible and materialised risks, either in on-site supervision or by (micro- or macro-) prudential regulation and policy making, and not by actively searching for new but yet unknown – or still relatively small but rapidly growing – risks.

20. It is therefore crucial for the EBA – working closely together with Member States' supervisory authorities, the other ESAs, the ECB and ESRB, and the European Commission – to build a 'market intelligence function' that aims at identifying and analysing - and subsequently addressing - harmful financial innovations *before* their consumer-related, prudential or systemic risks materialise, rather than 'after the bubble bursts', as market participants, regulators and supervisors have learned when looking back at the previous banking crisis and the period leading up to that.

Annex 1 - Survey on consumer protection issues

1. Role of the Sub-Group on Consumer Protection (SGCP)

1. The EBA’s Standing Committee on Financial Innovation (SCFI) has set up two distinct sub-groups to support it in carrying out its tasks. These are the Sub-Group on Consumer Protection (SGCP) and the Sub-Group on Innovative Products (SGIP).

2. Therole of the SGCP is to identify problematic issues relating to retail banking customers, i.e. issues which raise concerns that some consumer detriment is resultingfrom certain banking activities or products, especially those of an innovative character.

3. At a high level, the SGCP has responsibility to identify issues of concern from a consumer protection point of view focused on banks (or credit institutions) and banking products and to assess their risk. In this way it supports the Standing Committee in fulfilling its role to assist and advise the EBA and to contribute to the EBA’s work programme in areas related to consumer protection[1].

4. The SGCP focuses on tasks such as developing binding technical standards and/or guidelines (where required), and on thematic issues such as access for the unbanked, switching, literacy, complaint handling, training standards and common disclosure rules.

5. One particular aspect of the definition of ‘financial innovation’ relates to the question of whether this covers activities of non-regulated entities that might have an effect on the banking sector. The SCFI has previously noted that this is an area which needs to be kept on the EBA’s ‘radar’ given its high potential for ‘risky’ innovation.

2. Methodology for the SGCPsurvey and report

6. The SGCP, on behalf of the SCFI,conducted a survey in late 2011 with a view to collecting information on major issues of concern with respect to consumer protection in each member state.

7. Competent authorities were invited to identify the top two major issues with regard to consumer protection in their respective jurisdictions.

8. Contributions provided by member states were analysed to identify key issues or trends which were common across countries. However, the SGCP acknowledges that issues or trends emerging even in only one or two

[1] In some areas, such as financial instruments covered by the Markets in Financial Instruments Directive (MiFID) which is an area of competence for ESMA, the EBA and ESMA would work closely together where such instruments are sold by credit institutions. This is expected to be the case particularly in relation to PRIPs (Packaged Retail Investment Products) which, according to the proposals for a revised MiFID are envisaged to be covered by it.

member states may ultimately pose risks to consumers either in those member states or more widely. For example, if a practice in one member state is copied by firms in another. Given this, all issues, even those which were not widely identified, have been considered by the SCFI. The findings of the analysis are presented in Section3. Trends, new developments and risks below.

9. In identifying issues, it must be remembered that this report is based on an *ad hoc* exercise conducted in the early days of the establishment of the SGCP and the SCFI. Therefore, it has not been conducted using a standardised reporting format or using a data collection exercise[2]. In 2012, to ensure the EBA can meet its role to identify trends, new developments and risks, the SGCP will give consideration to how this exercise can be carried out more formally and what data/ trends/ information should be collected by the EBA. This will form part of the future work plan for the SGCP.

3. Trends, new developments and risks

10. Based on the European Commission Eurobarometer Survey report from January 2009[3], which includes an analysis of the consumer base for each service type, it is possible to make an approximate determination of product ownership levels which gives a good indication of the usage of financial services across the EU.

11. Based on thissurvey, the ownership of a current bank account is the service with the highest penetration rate: 87% of EU citizens have such an account. Two-thirds (66%) have car insurance and a similar number (65%) said they have home insurance. Finally, two further retail banking products are used by about a fifth of the sample: mortgages are held by 22% and long-term credit loans (i.e. lasting more than 12 months) had been taken out by 19% of respondents.

12. In terms of the work of the EBA, in summary, the following topics were agreed among competent authorities to be the main areas on which to focus the efforts from a consumer protection point of view. It should be noted that the results presented in this list reflect the limitation imposed to the number of issues that each competent authoritywas asked to identify as a maximum (two issues). The competent authorities of several member states, however, share these consumer protection concerns:

- Indebtedness and Responsible Credit

[2]It should be noted that the information collected from Member States is not exhaustive and, in some cases, is not based on statistics and data.

[3]The fieldwork was conducted from 27 June to 1 July, 2008. Over 27,000 randomly selected citizens aged 21 and over were interviewed in the 27 EU Member States. Interviews were predominantly carried out via fixed-line telephones, approximately 1,000 in each country. The report can be found at: http://ec.europa.eu/consumers/strategy/docs/FL243_Summary_Final.pdf and the full analytical report at http://ec.europa.eu/public_opinion/flash/fl_243_en.pdf

- Financial Literacy and education
- Complex Savings Products
- Bank account fees and charges
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3.1 Indebtedness and responsible credit

13. The global financial crisis and the on-going challenging economic environment has led to concerns regarding indebtedness in many member states including concerns about over-indebtedness, arrears and foreclosures and how such issues might be avoided in the future (so-called responsible credit). These issues span both mortgage lending and non-mortgage (or personal) lending, e.g. overdrafts, term loans, hire purchase, credit cards and other personal loans. Given the severe consequences for consumers (and enterprises) arising from over-indebtedness situations (and also the relevance of this subject to the stability of the financial system) this topic warrants special attention from banking sector regulators. [See for example, the FSB Principles for Sound Residential Mortgage Underwriting Principles, under consultation until December 9th, 2011].

14. From our analysis of the top issues/risks identified by competent authorities, it is clear that issues around indebtedness are multi-faceted. Actual levels of indebtedness and/or levels of arrears were identified by many member states.

15. Othertopics include:

    - the role of intermediaries in the provision/granting of credit;
    - while the transposition of the Consumer Credit Directive[4] (CCD) has reinforced the means of prevention of over-indebtedness (adverts, solvency examination of the borrower), problems linked to unemployment and lack of revenues remain;
    - also in relation to CCD, lack of clarity regarding when pre-contractual information should be provided;
    - issues relating to specific mortgage products, for example consumers being incentivised to move off mortgages which track/ follow ECB interest rate movements;
    - product innovations such as negative equity mortgages which allow a homeowner in negative equity to carry their existing mortgage to a new property;
    - reversion of interest-only mortgages to capital and interest payments which are unaffordable given currenteconomic conditions;
    - inability of consumers to influence their own financial futures as they are in negative equity and are struggling to make ends meet;

[4] Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers.

- households seeking loan restructuring and related complaints about the resulting terms and conditions;
- consumers opting for floating interest rate loans without taking into account how possible future interest rate increases would affect their monthly instalments.The upward trend in interest rates earlier in 2011 had increased consumer financial obligations;
- poor underwriting practices coupled with lack of assessment of the borrower's ability to repay;
- difficulties with creditworthiness assessments for consumers with lower credit ratings, e.g. students who have a low credit rating now but may have significant affordability in future;
- the financial market crisis has raised the specific risks associated with foreign currency loans; and
- increasing complexity of mortgage and other credit products was identified as becoming an increasingly common feature.

16. Many countries have taken steps to address these issues, including regulating the conditions to grant a mortgage (ratio of debt to income, amount of personal funds, information to be given on variable rates, etc.) but the range of solutions recently adopted highlight the multifaceted nature of the problem as identified above in that competent authorities have used different mechanisms to address different aspects of the problem depending on the circumstances in their own country, for example:

    - rules so that new loans should not exceed a specified percentage of the home's market value;
    - codes of conduct which the lenders must follow, e.g. regarding the process of engagement between the lender and mortgage holder to come to an arrangement on revised repayments;
    - specific provisions to help households restructure their debts in order to avoid the effects of default (evictions, foreclosures etc.);
    - standards that must be followed by credit institutions when granting credits and which in some cases refer to the need for promoting responsible lending to consumers;
    - guidelines for prudent lending practices to limit the extent of high debt, both compared to income and to property value, e.g. loan to value of 90%, total debt to gross income (3X), consequences of interest rate increases, thorough credit appraisal;
    - actions to limit the possibility of excessive lending through a number of recommendations on good practices in risk management of retail credit exposures including on exposures secured on real estate and mortgage; and
    - strict criteria on the granting of new foreign currency loans to private consumers.

17. In terms of future work for the SGCP a wide range of issues could be considered. However, it is noted that the Consumer Credit Directive (CCD) and the forthcoming Mortgage Credit Directive[5] (MCD–which is currently

[5] Directive on credit agreements relating to residential property for which see http://ec.europa.eu/internal_market/finservices-retail/credit/mortgage_en.htm.

under negotiation) aim to address many of the past failings and thereby prevent re-occurrence of such problems.

18. The CCD has set out very important rules concerning the provision of information, adequate explanations and rules on advertising when granting a consumer credit. Assessing the solvency of the borrower has been made compulsory. Such rules are already foreseen in the draft MCD. It appears, therefore, (but this would have to be confirmed by the outcome on the negotiations on the MCD), that the MCD project could potentially address completely or partially some of the issues raised by the SGCP members, such as:

- The pre-contractual information (Article 9(2)) including information on variable rates and foreign currencies loans, and simulations where applicable (Annex II, part B, Sections 5(3) and 6(4);
- The activity of credit intermediation raises serious concerns given the role these agents have in the credit granting process; (the proposal for MCD covers the intermediation of mortgage credit agreements only, i.e. not other credit agreements). The proposal aims at preventing conflicts of interests (Article 5) and intends to allow for an effective supervision of credit intermediaries (Chapter 9) as well as competence requirements for staff (Article 6).
- Concerning the sharing of responsibilities between the bank and its intermediary, as well as the control that the credit institution could have on the selling practices of the intermediary,the MCD gives flexibility as regards who provides information to the consumer. However, it should be underlined (i) that information is to be provided in all cases (by the creditor or the credit intermediary, depending on the transposition into national law or if not foreseen in national law, on arrangements between the creditor and the credit intermediary) and (ii) that some tasks will be of the sole competence of the creditor, e.g. the creditworthiness assessment.
- The compulsory examination of the creditworthiness of the borrower (Articles 14 and 15).

19. Whilst the MCD sets standards as to when advice is provided (Article 17), as well as the obligation to offer credits that are not unsuitable for the consumer given his needs, financial situation and personal circumstances (Article 14(4)), the MCD does not define specific criteria to avoid over-indebtedness, such as a loan-to-income ratio, or for countries where a loan-to-value is applied, a limitation of this ratio to prevent negative equity cases. However, the proposal contains an obligation for the creditor to refuse to grant a credit to a consumer, where it appears that the consumer is not likely to meet theirdebt obligations (Article 14(2)).

20. The MCD project foresees that the EBA should define binding technical standards, for example for professional insurance for intermediaries, and intervene in cases of a conflict between authorities or in a banning case, as foreseenin Article 9 of the EBAregulation. The MCD is currently under

discussionboth at the Council of the European Union and at the European Parliament (A vote in the Plenary has been penciled in for May 2012).

21. In addition to the development of the above-mentioned European Directives, in October 2011 the European Systemic Risk Board (ESRB) released recommendations on lending in currencies other than the legal tender of the relevant country ('foreign currency lending') addressed to the Member States of the EU, their national supervisory authorities and the EBA. Implementation deadlines vary between June 2012 and December 2013 depending on the recommendation and addressee. These recommendations need to be adequately taken into account by relevant national authorities, in accordance with the implementation deadlines set by the ESRB[6]. Legislative/regulatory measures are being adopted by several member states to address these recommendations (although the scope of these measures is broader insofar as it not only refers to foreign currency loans but also to responsible lending practices)[7].

22. In addition to measures designed to prevent over-indebtedness situations, consideration could also be given by the SGCP to the treatment of foreclosure and insolvency situations.

23. The work plan of the SGCP also already identifies drafting of one set of Binding Technical Standards (BTS) for the MCD to be produced within 6 months of adoption of the directive. There may also be a need to provide advice and/or other input (such as guidelines) which will depend on the final text of the directive. In addition, in the future, there may be a need to contribute to the review of these rules as a regular recurring task at periodic intervals.

3.2 Financial Literacy and Education

24. Financial education is an area specifically identified within Article 9 as being within EBA's area of competence in terms of reviewing and coordinating financial literacy and education initiatives by the competent authorities. This is an area of particular challenge as the delivery structure for financial literacy and education varies across member states. For example, some competent authorities have a specific mandate in this area. However, in others, either another separate authority is competent (and this may not be a central bank or regulator), or theremay be no specific authority with such a mandate.

[6] http://www.esrb.europa.eu/pub/pdf/recommendations/ESRB-2011-1.pdf?9068ed2c99eb1f47768545c3c19ab625

[7] For more details, please refer to the ECB opinions on these legislative initiatives:

http://www.ecb.europa.eu/ecb/legal/pdf/en_con_2011_87_f_sign.pdf

http://www.ecb.europa.eu/ecb/legal/pdf/en_con_2011_67_f_sign.pdf

http://www.ecb.europa.eu/ecb/legal/pdf/en_con_2011_74_f_sign.pdf

25. Concerns about financial literacy/education were identified in a number of member states, in particular:

- increasing amounts of pre-contractual information and disclosure to consumers (disclosed as a result of the increasing complexity and diversity of the products and business practices in the retail banking market) which can sometimes result in consumers simply being provided with too much information which they cannot understand or interpret, as it is too complex or too detailed and is therefore ignored; and
- consumers may not understand the consequences of their decision/purchase and may not fully comprehend their obligations or their rights or the protections offered by conduct of business rules, so for example, they may not complain if they are dissatisfied with any unfair treatment.

26. The European Commission adopted a communication on financial education in 2007, where it set out best practices in the area of financial education. Since then, it has decided to refocus its activities in this area by primarily relying on the work carried out in this respect by the OECD and the International Network on Financial Education. The European Commission continues to support a dedicated website (www.DOLCETA.eu) which is an on-going online consumer education project involving the 27 countries of the EU, financed by the European Commission (EC). DOLCETA offers online modules which focus on different consumer topics such as consumer rights and financial services. The EC has also developed a pilot project to train non-profit entities that provide general financial advice to consumers.

27. The SCFI recognises the importance of the OECD International Network on Financial Education (INFE) in the development of principles and guidelines on financial education - as has been underlined by the G20 'High Level Principles on Consumer Protection'.

28. It is considered that this is an area of commonality across the European Supervisory Authorities (ESAs) and therefore, given commonalities in the themes it was suggested to handle this atthe Joint Committee level. The SGCP does not plan any specific initiatives in this area pending consideration by the Joint Committee. However the SGCP considers that the solution for financial literacy should not necessarily be found in increasing regulation on disclosure and transparency.

3.3 Complex Savings Products

29. One of the key challenges for consumers and for regulators in dealing with conduct of business issues is the complexity of products. Such complexity makes it difficult for consumers to understand costs, risks and benefits of financial products and to make choices that are in their best interests. Complex products have been and continue to be an area where there is a risk of consumer detriment. Indeed, some countries, in response to our survey, commented on the increasingly complex nature of products.

30. Specific issues relating to complex products varied across member states in our survey of key issues/risks, for example:

- alleged mis-selling; and
- use of oral advice/information by those selling products to consumers which can lead to alleged mis-selling and makes demonstration of compliance difficult, i.e. how can you verify what the customer was told about the product.

31. Some countries have taken specific steps to mitigate some of these risks, e.g. a traffic light system which labels financial products with green, yellow or red, according to the products' complexity and the risk of loss; education/training standards for those selling such products;pre-approval by the supervisory authority of all advertising and pre-contractual information regarding complex banking savings/investment products; and codes of conduct addressed to credit institutions regarding sales practices.

32. It has been observed, however, that some concerns in this area are, to some extent, taken into account in the revision of the Directive on Markets in Financial Instruments (MiFID II and MiFIR II), as well as in the Packaged Retail Investment Products (PRIPs) initiative. With the revision of MiFID, structured deposits will fall under the scope of MiFID and will therefore be subject to specific conduct of business rules. Given that structured deposits are banking products, this will require some co-ordination between EBA and ESMA, since MiFID primarily falls under ESMA's responsibility.

33. Steps which would simplify the market and render it more transparent, regardless of the form of the product being distributed, would appear to be of benefit in these cases. This would help consumers to gain greater insight into the choices facing them, enhance the comparability of the various products and foster competition.Confidence in financial institutions and the smooth operation of the financial markets will be strengthened as a result. Experience in some countries raises the question of whether some form of product regulation should be considered and, if so, what form, as this could vary widely from pre-approval/clearance of products by a regulator before the sale to retail consumers, to standard risk labelling (such as a traffic light system), to no intervention. Before considering any further work in this area it is necessary to understand the final proposals in relation to PRIPs and the outcome of the MiFID review. Once these are available, the SGCP will return to this topic to evaluate whether any action is needed, and will liaise, to that end, with the other two ESAs.

3.4 Bank Account Fees and charges

34. Our analysis of risks/key issues in member states highlighted concerns about pricing including consumer complaints about excessive charges, lack of transparency, clarity and/or accuracy about pricing and cases of overcharging which ultimately lead to refunds being made to customers. Issues in relation to fees and charges raised related both to services

covered by the Payment Services Directive and services which are not covered.

35. In August 2010, the Commission invited the European banking sector to provide an ambitious response to the need for significantly increased bank fee transparency and comparability.More than a year later, in view of the inability of the European banking industry to reach consensus on an appropriate solution, the Commission has decided to work towards presenting, by the end of the year 2012, a legislative package on bank accounts. The SGCP, as part of its work program for 2012 will provide advice/views in relation to the Commission proposals.

3.5 Unnecessary sales

36. As noted in section 3. Trends, new developments and risks above, a key area which consumer protection aims to address is the sale of a suitable product. This is generally achieved through:

- fact finding exercise so the firm understands the customers' circumstances, needs and objectives; and
- suitability assessment so the firm sells a product which suits the needs of the customer and is suitable for them.

37. This is a crucial element of the product sales process because the sale of an unsuitable product can have long term consequences for consumers, e.g. a mortgage product will be repaid over many years; or in many cases an unsuitable sale may only be uncovered far into the future, e.g. in cases of long term saving or investment products if a problem is only uncovered on maturity it will be too late to rectify the situation and extremely difficult to consider complaint/redress given the passage of time.

38. A number of countries identified unsuitable sales as areas of concern or risk for consumers in their member state. Some differing aspects were identified including:

- Consumers are often not properly informed by service providers about their products, consumer rights and obligations;
- Because of low levels of financial literacy, a complex market and complex products, there are large risks, when the consumer is choosing a financial product, that it will be unsuitable;
- Many companies offer financial advice and their motivation is not always to the benefit of the customer, i.e. a suitable sale;
- The sale of payment protection insurance in conjunction with loans was specifically identified by some.

3.6 Impact of Technology

39. The fast speed of technological developments associated with the retail payments' market raises a number of supervisory concerns, in particular regarding the need to ensure the security of operations conducted through innovative channels, such as internet and mobile payments. These

technological developments have been accompanied by increasingly sophisticated fraud attempts, despite the efforts of institutions to put in place appropriate security mechanisms. Concerns regarding the lack of security and/or confidentiality constitute an important restraint to the development of internet banking and credit card online payments (which, in turn, limits the development of some economic segments such as e-commerce).

40. Internet and mobile banking also raise supervisory concerns in relation to the need to put in place adequate mechanisms to ensure the enforcement of existing market conduct rules (e.g. information disclosure requirements) when banking products are contracted through these new channels.

41. ThePSD will be reviewed during 2012, providing an opportunity to consider some of the aboveissues.

42. Supervisors may need to consider reviewing the implementation of high level safety standards by financial institutions, which must be up to date with technological developments.Other banking conduct supervision areas such as information disclosure requirements and financial education are also of paramount importance to address some of the identified problems. Consumers have to be made aware of the need to follow essential safety measures in the prevention of fraud situations and criminal attacks. They have also to be educated on how to implement some of these measures – as most online banking consumers do not possess, for instance, the necessary technological knowledge to prevent internet-based attacks.

3.7 Comparison websites

43. It is widely acknowledged that a key objective of consumer protection is to address information asymmetry for consumers by providing clear and comprehensive information. This includes information on cost. Given this, it would appear that price comparison websites would be a useful tool, when it is ensured that they operate in an independent manner.

44. The European Commission Eurobarometer Survey report from January 2009 analyses consumers' views on switching service providers. Among its main findings, it states *inter alia* that:

    - A significant proportion of the respondents to the Eurobarometer survey find it hard to compare offers.
    - The proportion of consumers that switched their service provider in the previous two years varied according to sector, with financial services such as current bank account (9%) and long term loans (10%) being among the sectors with the lowest.
    - Consumers were asked to evaluate a number of tools to see whether they were helpful when deciding about retaining a service provider or changing to a new one. The 'most wanted' tool was a switching process that costs nothing; on average, a third (32%) of consumers indicated that this would help them. The other two highly-regarded areas of assistance were both related to information: the ability to have

standardised comparable offers and a website where the various offers were compared.

45. This research would suggest that price comparison websites would be viewed favourably by consumers and indeed they were positively identified by some countries as such.

46. However, concerns with such sites were also identified, for example regarding the independence of some such websites, e.g. if they are owned by an intermediary or are funded by one or more financial institutions or intermediaries. Such websites may recommend one or more specific products to the customer but they may fail to give advice that suits the customer's needs, among other reasons because of the shortcomings of the questionnaire to be completed by the customer, e.g. it is too standardised or there are too few questions to capture accurately all relevant eligibility or risk information.Another factor of risk may lie in the absence of clear information about what elements are taken into account to rank the policies and, above all, whether price is the only driver of the comparison or quality aspects are also considered.

Annex 2: Exchange-Traded Funds (ETFs)

1. Introduction

1. The fast growing Exchange-Traded Fund (ETF) market is discussed in several international *fora* and in the press. Exchange-Traded Product (ETP) is the generic name for securities that are listed on an exchange and which track a basket of securities, usually an index or benchmark. The majority of ETPs in Europe are mutual funds, referred to as ETFs, which typically invest in equity and fixed income indices. Other ETPs include Exchange-Traded Notes (ETNs) and Exchange-Traded Commodities (ETCs), which are listed debt securities. The focus in this document is on ETFs.

2. The Bank for International Settlements[8], the Financial Stability Board[9], the European Securities and Markets Authority[10] as well as several national supervisory authorities have addressed ETFs in their working and discussion papers. In this document the EBA's SCFI is presenting its analysis of ETFs from a banking supervision perspective, covering the several types and structures of ETFs and their regulation and supervisory treatment. The last section outlines the risks involved from different perspectives and proposes follow-up work, given that this report is a first exploration of this issue from a banking supervision perspective.

2. Main Supervisory Concerns

3. Preliminary findings suggest that, from an investor perspective, the main concerns are related to counterparty credit risk as the return onETFs depends on the ability of contract partners to fulfil their respective obligations. This is true in particular for synthetic ETFs, where the intended exposure on the benchmark being tracked is gained through a Total Return Swap (TRS) and through security lending of the securities owned by the ETFs. Due to insufficient transparency requirements, an ETF investor might not be aware of the composition of the underlying portfolio, the structure of the ETF and whether or not the fund lends its securities. High quality collateral, over-collateralization and contractual limits to swap values are the main ways for reducing counterparty credit risk. Additionally, there is no agreed taxonomy for describing ETFs, and marketing and promotional material may fail to highlight the differences among different ETF structures.

4. Banks, on the other hand, face market risk deriving from commingling risks when involved in different roles (as ETF providers or parent entities of an

[8] BIS Working Papers, no. 343, Market structures and systemic risks of exchange-traded funds, April 2011.

[9] Potential financial stability issues arising from recent trends in Exchange-Traded Funds, 12 April 2011.

[10] ESMA Discussion paper: ESMA's policy orientation on guidelines for UCITS Exchange-Traded Funds and Structured UCITS, July 2011.

ETF provider, as swap counterparties to synthetic ETF transactions, as authorized participants in both physical and synthetic ETFs, and as market-makers/distributors); further, transparency issues also arise here. Moreover, banks might use synthetic ETFs as a source of collateralised borrowing for less liquid assets: in times of stress this might pose funding liquidity risks. Since major investment banks are involved in swap activities, problems affecting any of them may have systemic implications. From a systemic point of view concentration of providers, contagion and exaggeration of market developments by ETFs are also source of concerns.

3. Description of ETFs

5. ETFs are investment vehicles providing investors with a return that is linked to a certain index or benchmark. ETFs are listed on a stock exchange or traded over the counter (OTC). The fund is managed by an ETF provider, usually an investment bank or asset manager. Authorised Participants (APs) can subscribe or redeem units in a fund in kind, typically in blocks of 20,000 to 200,000 shares. These APs are registered with the fund. They sell the shares on the secondary market through exchanges or OTC to end investors; mainly institutional and retail investors.

6. There are several ETF types: physical, synthetic, leveraged, inverse and actively managed. The physical and synthetic types are discussed in detail below, given that these are the most common. Leveraged ETFs use derivatives such as options and futures to obtain the leverage. In the past years innovations in the market have seen the emergence of different types of ETF structures including leveraged (+/- 2, 3, 4 times) and inverse ones. While the leverage is achieved by adding derivatives to the underlying portfolio of the fund, an inverse ETF is constructed by using various derivatives for the purpose of profiting from a decline in the value of an underlying benchmark. As exchange-traded funds (ETFs) are traditionally designed to track indexes, actively managed ETFs emerged recently to allow investors to invest in ETFs that pursue a particular investment objective that aims to deliver above-average returns.

3.1 Physical ETF structure

7. In case of a physical ETF the provider receives the underlying securities from the APs in exchange for creation units. The provider can also receive cash from the APs for the creation units and buys the underlying securities of the index (or a sample of it) itself. The provider manages the fund and is permitted to conduct security lending. Since the value or the composition of an index can change, the index might be too broad for (exact) replication or because of administrative fees and costs there might be a tracking error: the (volatility of) the deviation of the return on the index from the return on the fund's portfolio. With the fees from security lending the costs of this tracking error can be reduced. For an illustration of the physical ETF structure, see figure 1.

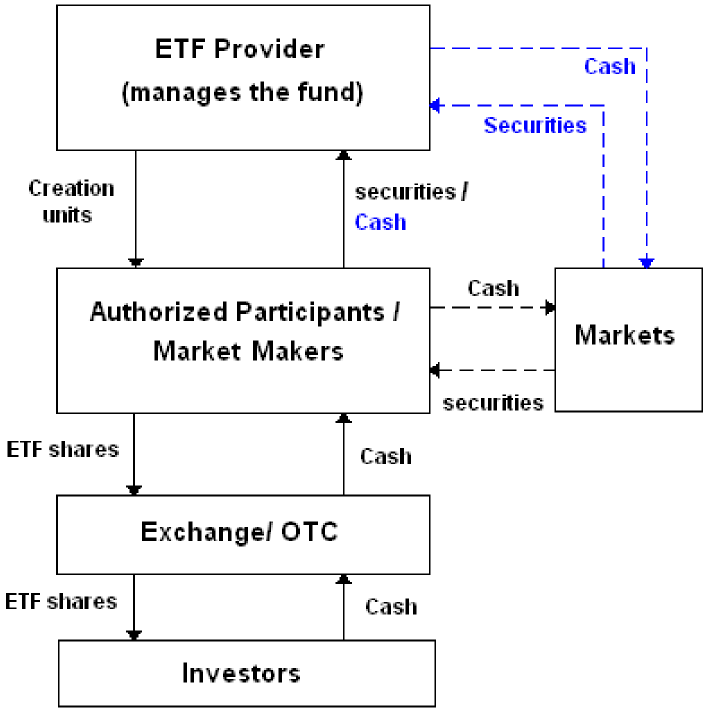


Figure 1: physical ETF structure (source: BIS WP 343/2011)

3.2 Synthetic ETF structure

8. In a synthetic ETF the APs transfer cash in exchange for the creation units to the ETF. The intended exposure on the index is gained through a Total Return Swap (TRS) with a counterparty – typically an affiliated bank of the provider. Depending on the bank or provider involved, there are two main synthetic ETF structures: the unfunded model and the funded model.

Unfunded swap model

9. The ETF provider invests the cash in a random set of securities or acquires the securities from the swap counterparty. Subsequently the provider enters into a TRS where the actual return on the underlying portfolio is exchanged for the index return. This swap will be subject to margining for Market-to-Market (M-t-M) movements. In case of a UCITS certification for the ETF, the collateral posted for the M-t-M movements of the TRS swap is subject to the UCITS collateral rules on derivatives[11] which state the minimum quality requirements for collateral and prohibit reselling or pledging of the collateral. However, in the unfunded UCITS structure no regulation applies to the underlying portfolio the fund holds. Therefore these securities may have any quality and may be used for security lending purposes.

[11]Box 26 of CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788).

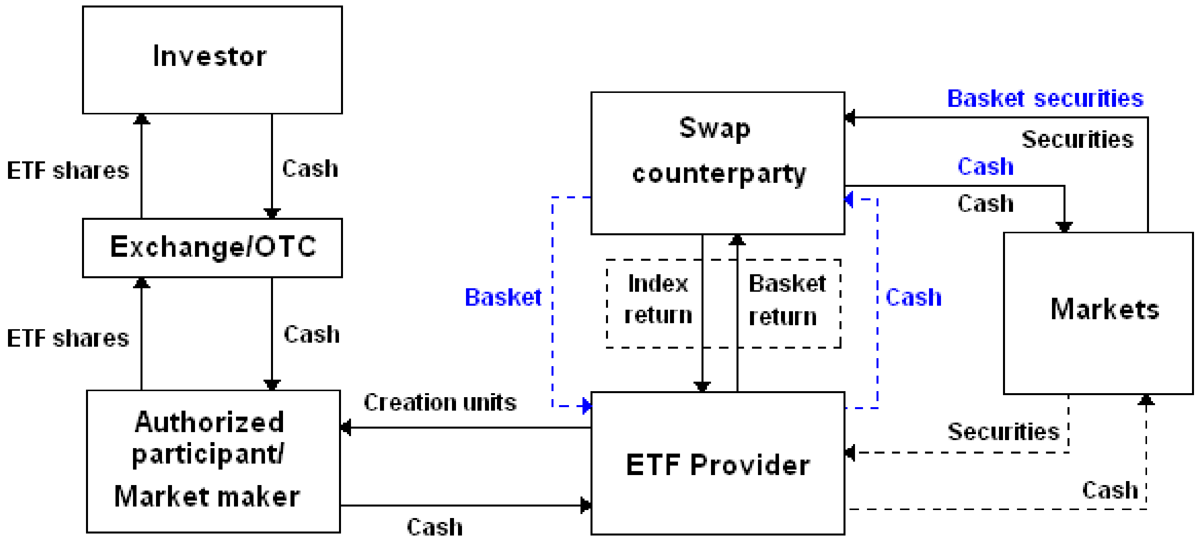


Figure 2: Unfunded Synthetic ETF (source: BISWP 343/2011)

Funded swap model

10. The ETF provider transfers the entire cash investment present in the ETF directly to the swap counterparty. In return for this cash payment, the swap counterparty will periodically pay the intended return on the index where the ETF is linked to it. In this structure the total return swap has a form of an equity-linked note. The swap counterparty is obliged to deposit collateral for the entire original cash payment by a ring-fenced custodian. In case of UCITS certification, the collateral for this transaction is subject to the UCITS regulation on derivative collateral which means that a certain quality is guaranteed. Usually this transaction is over-collateralised by 0−20%. The main difference with unfunded funds is that the entire investment of the ETF holders is collateralised under UCITS rules, whereas by an unfunded swap these rules only apply to the M-t-M movement of the swap value; no restrictions apply to the securities in the fund.

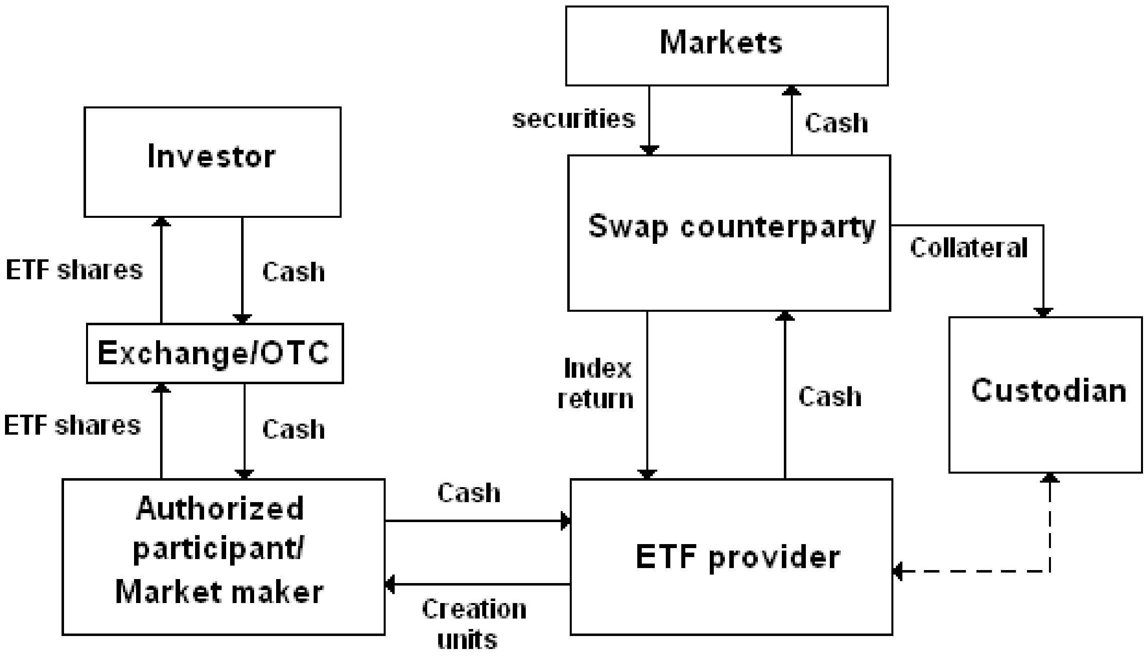


Figure 3: Funded Synthetic ETF (source: BISWP 343/2011)

3.3 Parties involved

11. There are several parties involved in ETFs: the fund provider, the authorized participants/market-makers, distributors and the end-investors. In the case of a synthetic ETF, there is also a swap counterparty involved. The ETF provider is usually a subsidiary of a bank or asset manager. In Europe, iShares (BlackRock), Lyxor Asset Management (Société Générale) and DB x-trackers (Deutsche Bank) together have a market share of 65-70% of assets under management (AUM). In case of synthetic ETFs the swap counterparty is typically a bank or a consortium of banks and is usually the parent entity of the provider. Investors are institutional and retail investors (US: 50/50, EU: 80/20). We understand that the principal EU investors in ETPs are institutional investors, including occupational pension schemes. Retail involvement in this market is currently limited because ETPs are accessed on an execution-only basis, i.e. without any advice.

12. Banks can be involved in the ETF market in different ways:

- as providers (or parents of providers)
- as swap counterparties to synthetic ETF transactions
- as authorized participants in both physical and synthetic ETFs
- as market-makers/distributors in both physical and synthetic ETFs
- as end-investors, although there is little evidence to suggest that banks currently form a material part of the investor base in ETFs.

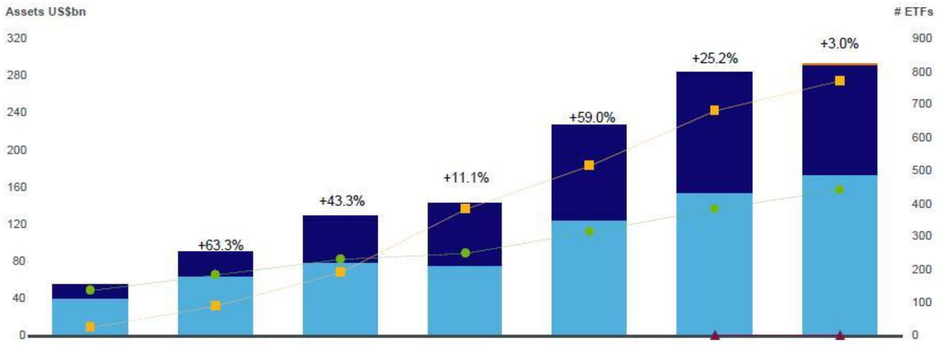
13. Usually swap counterparties and APs are affiliated with the provider (and each other). There are ETFs for which one bank is swap counterparty, authorized participant and market maker, and also affiliated with the provider.

14. The growth of the ETF market has different reasons. From an investor perspective ETFs are cost efficient (low fees). They give an exposure to a diversified pool of assets and, unlike traditional funds, ETFs trade continuously on exchanges, in a similar way to stocks which offer intra-day liquidity. Through synthetic replication strategies, investors have the ability to invest in a range of asset classes which may otherwise be inaccessible or prohibitively expensive to access (e.g. emerging markets, commodities). At least, many ETFs provide transparency on the portfolio on a very regular basis, often daily, which is not the case for many other mutual fund products.

15. The fund providers earn on high fund volumes (relatively low fees) and they enhance the performance of the fund by securities lending or dividend enhancements. The fund manager or swap counterparty can use their own lower quality securities on the balance sheet as collateral in a synthetic fund which may enhance the liquidity position of the particular party. The market-making is done by the APs who can arbitrage between the price of underlying securities and the ETF price. The synthetic ETFs can provide funding support to banks and a reliable business flow to affiliated swap desks on which they can earn spreads through a variety of transactions.

3.4 ETF Market

16. The total number of ETFs as of the end of October 2011 amounted to2,950, including equity, fixed income and commodity assets. Global ETF AUM rose from $74.3 bn in 2000 to $1,386.1 bn in October 2011. In Europe, from $0.7 bn in 2000 to $292.5 bn in October 2011, of which 60% are physical (see figure 4). In the US, due to regulation which prohibits TRS in the funds' portfolio (see next point below), there are hardly any synthetic ETFs. However, leveraged ETFs are permitted and form 3% of the US market and count for 20% of the daily turnover in the US. In Europe, hybrid ETFs, which combine physical with synthetic replication, form less than 1% of the market.



Assets (US$bn)	2005	2006	2007	2008	2009	2010	Oct-11
Physical	41.3	64.1	80.6	76.4	125.0	155.1	173.7
Synthetic	13.6	25.6	48.0	66.4	101.9	128.6	118.5
Hybrid	–	–	–	–	–	0.3	0.3
ETF AUM total	54.9	89.7	128.5	142.7	226.9	284.0	292.5
# physical	138	184	231	252	314	385	442
# synthetic	27	89	192	383	515	683	773
# hybrid	–	–	–	–	–	3	3
# ETFs total	165	273	423	635	829	1,072	1,218

Note: Synthetic replication refers to the use of derivatives to replicate the index performance such as swaps, futures, forwards, options etc. Physical replication refers to the use of physical securities such as stocks, bonds and commodities to generate the index performance. Hybrid replication refers to a combination of both physical and synthetic products. Data as at end of October 2011.
Source: BlackRock Investment Institute, Bloomberg.

Figure 4: ETF market growth in Europe (source BlackRock Landscape)

4. Regulatory and supervisory treatment

17. In the US, ETFs are treated mainly as open-ended funds or unit investment trusts and are registered under the Investment Company Act 1940. Under this Act, the use of derivatives in a fund is limited, therefore synthetic ETFs with a TRS hardly exist in the US. However, it is considered that there is no 'high usage' of derivatives in the case of leveraged ETFs, which use derivatives such as options and futures to some degree to obtain the leverage. Such leveraged ETFsform 3% of the total ETF market in the US. Since March 2010, the US Securities and Exchange Commission (SEC) reviews the use of derivatives in open-ended funds and ETFs. Since then funds with a high usage of derivatives are not allowed. Since 2008 the SEC also gives permission for some actively managed funds.

18. Another distinct feature of the US market is the still-existing possibility of naked short selling applying to equities including ETFs. In Europe, the naked short selling remains prohibitively expensive. By allowing naked short selling, more fund shares can be traded then actually created by the APs. This does not mean that the shares created by short selling can be redeemed.

19. In Europe ETFs can be established under the UCITS Directive similar to mutual funds. Under the UCITS Directive, limited prudential requirements are established for the funds, which include, for example, the segregation of assets and the diversification of the portfolio, but not capital requirements.

20. For each ETF (UCITS or not) a prospectus is available. The UCITS IV Directive requires that the prospectus must contain a description of the fund's investment policy. However, providers are not obliged to update the information on the portfolio that they hold or to specify the replication mechanism (i.e. the mechanism for replicating the tracked index or

benchmark) or whether the fund is UCITS regulated. In the case of a synthetic ETF this is even less transparent, since the swap counterparty can decide which securities to hold or which collateral to post, as long as it complies with UCITS regulation. However in the meantime several ETF providers publish details on e.g. the composition of the (collateral) portfolio on their websites, in some cases even daily. UCITS does require funds to mention whether transactions in financial derivative instruments are authorised. In that case it shall include a prominent statement indicating whether those operations are for the purpose of hedging or to meet investment goals. The possible outcome of the use of financial derivative instruments on the risk profile should also be included. Although there is no protection schemes for ETFs as there are fordeposits, there are a number of investor protection measures in place for UCITS ETFs.

21. The UCITS directive is not developed specifically for ETFs. In July 2011 ESMA issued a discussion paper setting out policy orientations on future guidelines for UCITS ETFs and structured UCITS. ESMA has identified the following topics for which guidelines should be developed: identifier, index-tracking issues, securities lending activities, actively-managed ETFs, leveraged ETFs, secondary market investors, and quality and types of collateral received. The consultation on this paper ended in September 2011.

5. Potential risks

22. The risks present in the operation of ETFs are categorised in: risks from an investor perspective, risks from a provider perspective, risks from a swap counterparty perspective, risks from a market maker perspective and risks from a market point of view.

5.1 Investor perspective

Counterparty credit risk

23. The ETF investor is exposed to various forms of counterparty credit risk. In the case of non-UCITS-compliant funds the investor is exposed to the credit risk of the provider. In synthetic ETFs the investor is also exposed to credit risk of the swap counterparty. The counterparty credit risk is mitigated by the collateral the swap counterparty has to post, but the collateral might be completely different from the index. This might lead to losses for the investor in case of redemptions or a default of the swap counterparty. In case of security lending – for both the physical and synthetic ETFs – the investor is also exposed to the credit risk of the securities borrower.

Risk from the tracking error

24. Physical ETF investors are exposed to market risk of the tracking error: the (volatility of) the deviation of the return on the index from the return on the fund. The physical ETF providers manage the underlying portfolio themselves. In this way, the investors are exposed to market risk due to

imperfect replication of the index by the ETF provider, for which the investor nevertheless has to pay a management fee. In case of a synthetic ETF, the investor has to pay the swap fee. Due to the costs a swap counterparty has, this swap fee can go up, which increases the tracking error.

Liquidity risks

25. Investors are attracted to ETFs by their low transaction costs and apparent provision of on-demand liquidity. But there is a risk, particularly during market stress, that this liquidity may prove illusory, with end investors and/or market makers unable or unwilling (in case of market makers) to redeem their ETF holdings at prices that reflect the net asset value (NAV). For ETFs referencing less liquid underlying assets such as emerging, commodity and corporate bond markets, this risk might be even higher.

Transparency

26. If a fund is UCITS regulated ETF providers are only obliged to report the investment strategy. An ETF investor might not be aware of the underlying portfolio, the structure of the ETF and whether the fund lends its securities. Therefore the investors might not hold enough capital for losses on the investment. In this case, investors might hold the providers responsible for the lack of transparency and file claims. In practice, however, recently, several providers have improved their transparency practices to daily reporting of portfolio composition and potential securities lending activities.

Taxonomy

27. Taxonomy is a major issue for ETF funds. There is no agreed taxonomy for describing ETFs, and marketing and promotional material may fail to highlight the differences amongdifferent ETF fund structures. The "Exchange Traded" name may now be a shield for a wide range of very different securities and we are concerned providers and promoters of ETFs may not sufficiently highlight key differences. Differences that current taxonomy fails to highlight include whether or not the ETF is a UCITS fund, whether the ETF uses a physical or synthetic replication strategy, and whether or not a synthetic ETF obtains collateral.

5.2 Issuer/Swap counterparty perspective

Counterparty credit risk

28. In case of a synthetic ETF, the provider is exposed to the counterparty credit risk of the swap counterparty. Under the TRS collateral is posted to mitigate this risk: when the swap value reaches a certain level of the NAV (rather low, typically 5%), the swap is closed, the differential value is paid and a new swap contract is implemented. The same holds the other way around.

Market risk

29. In the case of synthetic ETFs, banks acting as swap counterparty have a contractual obligation to provide the index return to the issuer. Depending on how this obligation is managed, banks might be subject to varying degrees of market risk, especially if the performance to be delivered is not sufficiently hedged internally or externally.

Risk from security lending

30. Physical ETFs typically lend out the physical underlying securities in which they have invested and synthetic providers might lend out the securities backing the swap. Losses could be incurred where the borrower is unable to return securities to the lender, particularly where collateral consists of illiquid assets.

31. Swap counterparties can also lend securities that are used to generate the index return for the provider. Losses could be incurred where the borrower is unable to return securities to the lender, particularly where collateral consists of illiquid assets.

Liquidity risk

32. To obtain the return on the index providers/swap counterparties might have troubles with rebalancing due to illiquid markets, low trading volumes or trading securities in emerging markets. Swap counterparties (banks) might use the synthetic ETF structure as a source of collateralised borrowing for less liquid assets. In times of stress, this might pose funding liquidity risks to swap counterparties. The recent trend of synthetic ETFs on less liquid or niche products puts risk to the swap counterparty in case of (sudden) ETF redemptions.

5.3 Market maker perspective

Liquidity risks

33. Market makers typically provide continuous intraday liquidity in ETFs. So they are exposed to (sudden) changes in the value of the shares between trading with investors and closing out those positions with the fund. Banks acting as market-makers might end up holding illiquid ETF shares for longer than expected, requiring stable funding to keep on to these positions. This risk might increase if ETFs themselves invest in increasingly illiquid underlying assets. Since major investment banks are involved in swap activities, problems affecting any of them may have systemic implications.

Market risk

34. Market makers create long and short positions in ETFs and hence they are exposed to changes in the value of the underlying exposures between trading the ETF with investors.

5.4 Market perspective

Short selling

35. Financial institutions that use synthetic ETFs for their funding are extremely sensitive to liquidity in the ETF market. Short selling of ETFs can impact prices heavily as with traditional stock exchanges, although it is not clear whether this raises particular issues with respect to ETFs. It could also be argued that short selling generally provides liquidity and aids price discovery. It is true, however, that short selling can lead to settlement delays.

Leveraged ETFs

36. ETFs offering leveraged returns represent a very small proportion of the ETF market. But turnover is on average much higher than for funds offering unleveraged returns. The fund creates the leverage by including futures and options in the fund's underlying portfolio. Leveraged ETFs might amplify dislocations in asset markets as a result of how they rebalance their exposures. Under the UCITS regulation only a +/- 2 times leverage is allowed.

5.5 Systemic risk concerns

Contagion risk

37. From a systemic point of view concentration of providers, contagion and exaggeration of market developments by ETFs are also source of concerns. There are several types and ETF structures. Problems with one type of ETF, might affect other ETF structures.

Concentration risk

38. The concentration among ETF providers increases the likelihood of failures at one firm impacting the whole ETF market. Only a few, big players are active in the ETF market, which also means that many ETFs have the same swap counterparty and (potential) problems with one counterparty can affect many ETFs. If a large ETF provider goes bankrupt, this also affects the swap counterparties and the APs, which are usually affiliates of the provider.

Exaggeration of market developments

39. As ETFs add an additional instrument to existing market arbitrage instruments (and indeed a cheap and flexible one), they are contributing to the complexity and interconnectedness in markets. Abrupt market developments could thus be exaggerated more easily.

5.6 Other issues

Market risk commingling and conflicts of interest

40. Since providers, swap counterparties and APs are usually parts of, or affiliated to, the same entity, market risk is transferred from one department ofan organisation to another. Thiskind of transactions might be

complex and non-transparent and make effective risk management and supervision harder.

41. As a result of the above, conflicts issues arise in relation to the operation of ETFs and can crystallise at any time, potentially exacerbating other risks identified in this document. Conflicts could exist in the following cases:

   a) Physical ETFs: conflicts can exist between the interests of the fund and the stock lending agent over sharing fees, the volume of stock lending activity and the quality of collateral.
   b) Synthetic ETFs: conflicts can existbetween the captive fund company and the swap counterparty over pricing the swap, achieving best execution, quality of collateral and custody arrangements.
   c) APs: Often, the AP is an associate of the same group which is running the fund and acting as counterparty to the swap, in the case where there may be a sole official market maker on a particular exchange. Conflicts may arise between the interest of the group in retaining assets and investors wishing to redeem.

ETF as funding instrument

42. Investment banks typically hold large inventories of securities from their normal trading activities. Banks divide this inventory into securities where lending fees are high and securities where lending fees are low. Banks directly lend securities where lending fees are high. Banks can use the remaining inventory to provide collateral to the ETF under the swap arrangements. In this regard, synthetic ETFs are no different from other arrangements to generate funding for banks via securities lending activity. As a result, ETFs are used to lower the bank's overall funding cost either by directly reducing the cost of holding inventory or allowing the bank to hold more risk on their balance sheet. Synthetic ETFs have two different impacts on bank's funding depending on whether the swap desk is able to hedge the swap exposure viaa transaction with a third party or purchases securities.

Operational risk

43. Often documentation and approval requirements are less strict for internal trades in comparison to external OTC or trades executed on exchange. This raises the potential of misuse by individuals.

6. EBA/SCFI Planned further work

44. The work of the SCFI so far has identified a number of risks associated with ETFs as described above. ESMA is currently working on a UCITS regulation for ETFs and the underlying securities. The consultation period ended late September 2011. This already may have an impact on the posted collateral by counterparties (banks) and the underlying baskets of securities. Therefore, SCFI will focus its efforts on identifying the risks to banks, whether they are involved as investors, market makers, providers or swap counterparties (or a combination of these). The aim is to assess whether there may be gaps in the regulatory framework for banks (e.g. market risk,

counterparty credit risk, liquidity regulation) that encourage banks' increased involvement in this market, with implications for the risk of the banking sector and the financial system as a whole.

45. The specific tasks envisaged for further work are as follows:

- Investigate the nature and extent of involvement of banks in EU member states in the ETF market, in order to establish the main players in the EU ETF market and the risks these players are exposed to.
- Analyse the prudential treatment of ETFs under the CRD where banks operate in various capacities in order to assess whether there any gaps that need to be addressed.
- Take appropriate actions to mitigate the prudential risks identified, in close co-operation with ESMA, either through regulation or supervisory intervention.