Box 2
The development and supervisory issues of Taiwan's ETF market

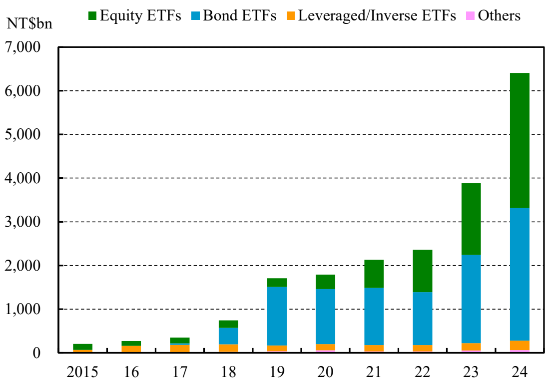
The development of Taiwan's ETF market began more than two decades ago. In recent years, the market expanded rapidly, driven by repeated record highs in the domestic equity markets, the appeal of high dividend yields, and expectations of US policy rate cuts. In particular, high-dividend ETFs saw a surge in fundraising that even led some retail investors to terminate time deposits or take out loans to invest in ETFs. This increasingly drew attention across sectors, including from the regulators. This box outlines the development of Taiwan's ETF market, highlights potential risks to investors and the financial system, and analyzes recent market challenges and regulatory responses, in the hope of providing a useful reference for policy deliberation.

1. ETF market development in Taiwan

1.1 ETFs have grown rapidly since 2018, initially driven by bond ETFs and more recently by equity ETFs

The first ETF listed on the TWSE was the Yuanta/P-shares Taiwan Top 50 ETF issued in June 2003. Following the gradual easing of related regulations, the ETF market began to develop, albeit at a slow pace. In 2018, the market experienced a breakthrough as a deregulation move excluded investments by life insurance companies in NTD-denominated bond ETFs from their overseas investment cap. This policy change attracted significant inflows and fueled rapid growth in bond ETFs. In more recent years, repeated record highs in the domestic stock markets and the rising popularity of high-dividend equity ETFs among investors have led to substantial growth in the equity ETF market (Chart B2.1). Meanwhile, expectations of Fed rate cuts starting from the second half of 2023 further boosted demand for overseas bond ETFs.

Chart B2.1 Types and Sizes of ETFs in Taiwan

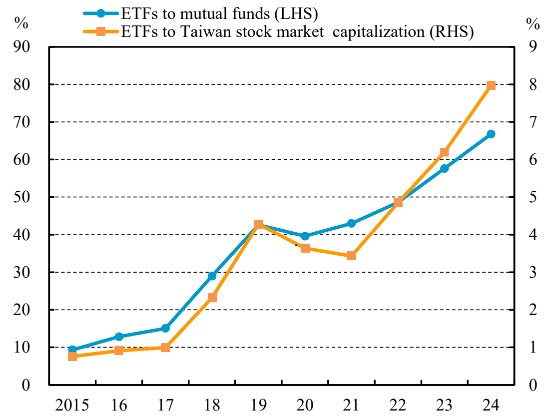


Sources: FSC and SITCA.

As of the end of 2024, the fund size of ETFs reached NT$6.4 trillion, representing a remarkable growth of approximately 32 times compared with that of NT$202.1 billion at the end of 2015. The number of ETFs increased sharply from 34 to 260 over the same period, and that of ETF investors also expanded substantially from 240,000 to 14.37

million, reflecting an increase of 60 times.[1] Since March 2023, the fund size of ETFs has officially surpassed that of regular mutual funds issued by domestic securities investment trust enterprises (SITEs). The share of ETFs in Taiwan stock market capitalization has also continued to rise (Chart B2.2), showing that ETFs have become one of the major investment products in Taiwan's capital market.

Chart B2.2 Comparison of the fund size



Sources: FSC and SITCA.

1.2 Trading value increased, but overall turnover rate was relatively low

The trading value of domestically listed ETFs was NT$6.7 trillion in 2024, representing a huge increase of 4.1 times compared to NT$1.6 trillion in 2015. However, over the past three years, the average annual turnover rate by trading value in the ETF market stood at 106.3%, which was lower than that of 124.0% in TWSE stock trading, reflecting not only the rapid expansion of the ETF market but also the fact that, unlike in the stock market, ETF investors usually prefer a "buy and hold" strategy that resulted in a lower frequency of transactions.

1.3 Domestic equity ETFs showed a high concentration in technology stocks

As of the end of 2024, many domestic equity ETFs tracking broad-market indices or adopting high-dividend strategies exhibited a high allocation to technology-related sectors (e.g., electronics and semiconductors), reflecting a notable industry concentration. For example, the top three ETFs by total assets under management were the Yuanta/P-shares Taiwan Top 50 ETF (0050, NT$436.1 billion), the Cathay MSCI Taiwan ESG Sustainability High Dividend Yield ETF (00878, NT$376.3 billion), and the Yuanta/P-shares Taiwan Dividend Plus ETF (0056, NT$363.8 billion). The abovementioned funds allocated 70.7%, 56.0%, and 61.0% of their assets, respectively, to electronics or semiconductor stocks.[2] The high concentration of these industries in domestic equity ETFs may weaken portfolio diversification, thus warranting close attention.

1.4 The recent regulatory approval of active ETFs and passive multi-asset ETFs has contributed to greater product diversification in the ETF market

To promote the development of the asset management market in Taiwan, provide impetus for asset management business growth, and support the policy objective of establishing Taiwan as an "Asian asset management center," the FSC amended relevant regulations in December 2024 to formally permit the issuance of active ETFs and passive multi-asset ETFs. In early May 2025, the first active ETF in Taiwan, the NEXT FUNDS – Nomura Taiwan SMART Select Active ETF (00980A), was listed. More active ETFs are expected to be introduced into the market in the future. However, investors should be aware that the performance of active ETFs is highly dependent on fund managers' investment capabilities and generally involves higher operational risk compared to passive ETFs. In addition, passive multi-asset ETFs may carry different levels of risk depending on their allocation strategies and equity-bond proportions. Investors should carefully evaluate their risk tolerance and select ETF products that align with their investment objectives and styles, ensuring both portfolio security and performance.

2. Potential risks of ETFs and market challenges in Taiwan

ETFs are widely favored by investors for such advantages as risk diversification and trading convenience. However, they may still involve certain risks. Moreover, the rapid expansion of the ETF market may also pose potential impacts to overall financial stability, which warrants close attention.

2.1 Potential risks to investors

(1) **Discount/Premium risk:** ETF prices in the secondary market are determined by market supply and demand. The prices may deviate from their net asset value, resulting in premiums or discounts that affect investors' actual returns.

(2) **Tracking error risk:** Tracking error refers to the difference between the returns of an ETF and those of its underlying index. Common causes of tracking errors include fund expenses, exchange rate differences between the trading currency and the denominated currency, etc.

(3) **Liquidation risk:** If an ETF is delisted upon regulatory approval, investors who purchased the ETF at a premium may be exposed to potential losses due to fund liquidation.

(4) **Liquidity risk:** ETF market makers are responsible for providing bid and ask quotes. If they fail to properly fulfill their quoting obligations or cease to perform such obligations, investors may face the risk of being unable to buy or sell ETFs.

2.2 Potential risks to the financial system

(1) **Systemic risk:** The "basket-trading" feature of ETFs may lead to more synchronized

volume and price movements among constituent securities. This can increase the frequency of simultaneous mass buying or selling, thereby weakening the effect of risk diversification and potentially amplifying systemic risk in the financial market.

(2) Stock price co-movement risk: During the periods of excessive market optimism or heightened uncertainty, herd behavior may emerge as some investors mimic the behavior of others, leading to concentrated buying or selling, thus exacerbating short-term price volatility.

(3) Concentration risk: If the underlying assets are concentrated in a limited number of companies, it may result in excessive correlation among constituent stocks, making the price movements across constituent stocks more aligned and thus reducing the diversification benefits of ETF portfolios.

2.3 Challenges of the ETF market in Taiwan

The recent investment surge in equity ETFs was driven by expectations of Fed rate cuts, domestic stock market rallies and high dividend yields. Meanwhile, repeated record highs in stock markets, combined with aggressive marketing campaigns by SITEs, have triggered a frenzy of buying among investors. Moreover, in order to boost distribution rates to attract investors, some SITEs misused the funds' income equalization reserves or even rebalanced their holdings frequently. Such practices may increase investment costs and erode returns, thereby potentially undermining the long-term interests of investors.

3. Regulatory framework and supervisory enhancements in Taiwan

To safeguard ETF market stability and protect investor interests, the TWSE strengthened product standards and information disclosure requirements for ETFs. The FSC also introduced multiple supervisory measures to promote sound development of Taiwan's ETF market.

3.1. ETF product regulation

Taiwan has not yet enacted dedicated regulations for ETFs. Instead, relevant provisions are dispersed across various regulations governing securities investment trusts, securities exchanges and the self-regulatory rules of the Securities Investment Trust and Consulting Association (SITCA). In addition, the TWSE has imposed eligibility criteria and standards on the components of the underlying indices. These include: (1) the components must be listed on domestic or foreign stock exchanges, (2) the components must be sufficiently diversified, with no single component security exceeding 30% of the index and the cumulative weight of the top five component securities not exceeding 65%,[3] and (3) the components must meet certain liquidity requirements. The TWSE also sets different liquidity standards based on the component characteristics of the index to ensure that ETFs are equipped with reasonable trading and arbitrage mechanisms.

3.2. Reinforcement of index compilation review mechanisms

The FSC required the TWSE and the TPEx to examine past performance when reviewing index compilation, so as to assess whether the constituent securities of an index are likely to be changed frequently. By managing the replacement rate of an index's constituent stocks through retrospective review, it would help to stabilize the investment structure of ETFs.

3.3 Disclosure of dividend sources and distribution orders

The FSC required SITEs to disclose the composition of sources of ETF dividends, so as to enhance market discipline. Furthermore, the distribution order shall be dividends from constituent securities, capital gains, and finally, income equalization reserves. These requirements aim to promote market self-discipline and information transparency, thus preventing investors from being misled.

3.4. Regulation of advertising and marketing activities

The FSC required the SITCA to develop a governance mechanism for advertising collaborations between SITEs and financial influencers and to formulate relevant self-regulatory guidelines. In addition, ETF advertisements are prohibited from using dividend payout rates or distribution amounts as the main headline or the primary promotional message. Moreover, high-dividend ETFs are required to include warning statements such as "no guaranteed income or dividends" to remind investors of ETFs' product nature and associated risks.

3.5. Wide-ranging enhancement of market supervision

The FSC strengthened its oversight of the ETF market through the following measures: (1) Supporting and monitoring SITEs in enhancing their assessment of the concentration and liquidity of constituent securities in the ETFs they issue and the indices they track, in order to keep stock prices and market liquidity from being excessively affected during position building and massive subscription or redemption; (2) Overseeing the TWSE and the TPEx in regular evaluation of ETFs' holdings and in building transaction databases to support stable market operations; (3) Drawing on the *Good Practices Relating to the Implementation of the IOSCO Principles for Exchange Traded Funds – Final Report* published by the International Organization of Securities Commissions (IOSCO) to enhance supervisory measures in the following three aspects, namely product structure, information disclosure, and liquidity provision; (4) underscoring ETFs as a focus in financial examinations, with the findings to serve as a reference for amending relevant regulations and self-regulatory practices.

4. Conclusion

Owing to their strengths in risk diversification, trading convenience, and cost efficiency, ETFs have emerged as an increasingly important tool for asset allocation. In recent years, as the size and the number of participants in Taiwan's ETF market have grown rapidly and product diversity has increased gradually, ETFs have gained significant and undeniable influence on the local financial market. However, rapid market expansion and growing capital concentration may also pose potentially adverse implications for the financial market, such as heightened market volatility, risk contagion, and excessive industry concentration, all of which warrant close attention. In line with its macroprudential supervision duties, the Bank will continue to conduct relevant research and monitor new developments as well as potential risks in Taiwan's ETF market. Additionally, the Bank will, as warranted by changes in the market, share its research findings through the supervisory communication platform in a timely manner, and work jointly with the FSC to safeguard financial stability.

Notes: 1. The number of funds and that of beneficiaries exclude offshore ETFs, futures ETFs, and leveraged/inverse futures ETFs.

2. Data on allocations to electronics and semiconductor stocks were collated from SITE websites as of January 2025.

3. In February 2025, the FSC indicated that if the proposed rule amendments by TWSE are deemed appropriate, the 30% cap on individual securities' weights in ETF underlying indices may be lifted.