BNY MELLON

EUROPEAN EXCHANGE TRADED PRODUCTS:

Momentum Builds for the ICSD Model

The European exchange traded product (ETP) market was valued at around $875 billion at the end of March 2020,[1] following the market turmoil that accompanied the rapid spread of COVID-19 and the subsequent shutdown of much of the global economy. While this was a significant fall from the record $1.03 trillion a quarter earlier, the ETP market recovered strongly in April. Sizeable positive net inflows, especially to bond ETFs and gold ETCs, underscored the ETP market's resilience and achievements as an investment instrument, as it celebrated 20 years since the first European products launched.

[1] https://etfgi.com/news/press-releases/2020/04/etfgi-reports-etfs-and-etps-listed-europe-reported-net-outflows-us2283

The ETP market is principally comprised of exchange traded funds (ETFs), although exchange traded notes (ETNs) and exchange traded commodities (ETCs) represent roughly a sixth of the total and are growing more rapidly than the market overall. Indeed, during the turbulent first quarter of 2020, commodity-linked products attracted inflows of $7.90 billion compared to outflows of $22.83 billion for the ETP market overall.[2] As well as expanding in size, the ETP market is undergoing a number of structural changes. The most important of these is the widespread shift to the International Central Securities Depositary (ICSD) model.

This change has been prompted in large part by Brexit. Irish ETFs represent approximately 62% of all European ETFs or around €430 billion.[3] The departure of the UK from the European Union means that Euroclear UK & Ireland (EUI) will no longer be able to provide issuer CSD services for Irish securities. Instead, these ETPs will in future be settled by Euroclear Bank in Belgium and Clearstream Banking Luxembourg. The migration of ETPs is underway and should be completed by the end of 2020. But while the Irish migration is a major event in the history of the European ETP market, it is also expected to pave the way for greater adoption of the ICSD model across the European Union and beyond.

This paper outlines why the migration of Irish ETPs to the ICSD model is likely to spur a more widespread adoption of the international model, both for existing ETPs and for products from new entrants to the European market. The paper provides a brief review of the Irish migration experience and a reminder of the benefits of the ICSD model. These developments are explained in the context of broader changes in the European ETP market, including its continued growth (largely at the expense of the active mutual fund sector), increasingly cross-border nature (both in Europe and globally) and possible further consolidation.

[2] https://etfgi.com/news/press-releases/2020/04/etfgi-reports-etfs-and-etps-listed-europe-reported-net-outflows-us2283

[3] https://www.irishfunds.ie/news-knowledge/news/press-release-assets-in-irish-domiciled-funds-reach-all-time-high-of-2.64-trillion-irish-funds

Irish ETPs: A Pivotal Moment for the ICSD Model

The migration of Irish ETPs to Euroclear Bank in Belgium and Clearstream Banking Luxembourg is still underway, although most managers have now secured a transition slot. EUI is treated as being an EU CSD until the end of December 2020 and will become a third country CSD in January 2021 (assuming the transition period is not extended). Therefore, emergency equivalence will be necessary from January to March 2021; the European authorities are aware of this and Euroclear expects this time-limited equivalence will be granted before the end of 2020. However, ETP migrations will be complete by the end of 2020 to free up the first quarter of 2021 for the migration of equities. As of December 2019, around €484 billion of the European market used the ICSD model, or 55%. Approximately €61 billion of further Irish ETP migrations are anticipated by the end of 2020, by which time 96% of Irish ETPs will use some form of the ICSD model.

While migration has yet to finish, no challenges have been experienced so far. This is due to impressive coordination between all market players: managers, ICSDs (both Clearstream and Euroclear), registrars, issuer agents, lawyers and regulators, including the Irish authorities. "It is also because many of the potential challenges were addressed some years ago when the first issuers adopted the international structure," explains Stephanie Lermusiaux, Head of FundsPlace at Euroclear. "At that time, CSDs, stock exchanges, authorised participants (APs) and others came together to find ways to remove inefficiencies and friction from the market. The result was the creation of a plan or runbook that provides a step-by-step process for migration to the international model or to create a new ETP using it."

Before the Irish migration, the pivotal event in the history of the ICSD model came in 2015 when BlackRock decided to migrate its iShares range to the model, consolidate its product range, and launch all new products using the structure. As the world's largest asset manager, BlackRock's decision to use the ICSD model provided comfort to the market. BlackRock's action was driven by a belief that a multinational central settlement and clearing venue for European securities would make ETF trading more efficient. The manager expressed a hope at the time that its decision would help to build a consensus across the industry around the benefits of the ICSD model.[4]

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[4] https://www.etfstrategy.com/blackrock-partners-with-euroclear-and-clearstream-to-migrate-20-ishares-etfs-to-international-settlement-structure-38278/

ICSD vs Domestic Settlement

Cross-exchange listed ETPs in Europe are issued and traded on one or more national stock exchanges and trades settle into the respective national CSD. Transfers of ETP positions between CSDs need to be reflected in the books of the ETP's transfer agent/registrar, triggering numerous operational challenges.

When ETPs are traded across borders, i.e. a firm buys an ETP listed in one market and then sells the same ETP in another market, the firm's trading desk is confronted with a complex post-trade process. The firm has to ensure that it moves the ETP from the national CSD where it has been bought to the national CSD where it is being sold.

Moving ETPs from one CSD to another in order to deliver the ETPs to the buyer in another market often requires the firm to have accounts with multiple CSDs, to align the firm's ETP positions among different CSDs and to follow different post-trade market practices in different markets.

Settling in a single pan-European location using the ICSD model delivers operational benefits through streamlining as well as reducing risk.

By simplifying post-trade processing of ETPs, the ICSD model enables market makers to offer more competitive trading spreads to investors, and also boost overall liquidity as a single European settlement location facilitates cross-border ETP trading. "Improved settlement efficiency results in spread reductions of 40%, making ETFs a significantly more attractive proposition for end investors and therefore likely increasing volumes for issuers," says Euroclear's Lermusiaux.

The ICSD model uses the proven efficient settlement infrastructure that Eurobond market participants have used for more than 40 years.

Migration to the ICSD model is straightforward: the process of moving from a domestic CSD to an ICSD is now tried and tested, not least as a result of the Irish migration. Migrations from other jurisdictions should be equally seamless as there is a lengthy and detailed runbook for migration.

As European ETP volumes continue to grow, efficient distribution will become ever-more important to managers.

The Next Wave of Migration

While the Irish migration is a unique experience, the imperative to migrate Irish ETPs has prompted managers active in Europe to reassess the models they use in various jurisdictions. Many managers compelled to migrate as a result of the Ireland situation also have ETPs domiciled in other European jurisdictions given the dominance of large issuers in terms of volumes. These managers are inevitably applying their experience of the Irish migration to other similar products.

“Many managers have had to address the migration issue for their Irish ETFs, noted the advantages of the international model, and have therefore begun to consider its more widespread application across their European products,” says Lermusiaux. “We are seeing a snowball effect.” The Irish migration has created momentum for a transition from a domestic model to an international model and is therefore expected to be a catalyst for change in the European ETP market.

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Head of FundsPlace at Euroclear

Even among managers not affected by the Irish experience, that migration has raised awareness of the international model. As a result, other issuers may be considering the ICSD model for the first time. Most obviously, it is increasingly seen as the first choice for managers that are planning to enter the European ETP market or other extant managers with ambitions to list products on multiple country exchanges. “Similarly, the broad trend among big managers towards cross-exchange listed ETPs as a means of consolidating their ETP offerings is likely to increase the appeal of the ICSD model,” says Rosa Scappatura, Head of ICSDs Relationships at BNY Mellon Corporate Trust.

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ICSD Model Viable Everywhere?

ICSD is a workable choice in European jurisdictions where a transfer agent (TA) is required, but its attractions are less compelling in CSD-model markets such as Germany. In other markets, such as Switzerland, which has characteristics of both a CSD- and TA-model market, ICSD offers some advantages over a domestic model for products that are listed on multiple exchanges. Of the TA model markets, Luxembourg stands out given its scale. There is anecdotal evidence that managers in the Grand Duchy believe that a tipping point has been reached in relation to adoption of the ICSD model.

Luxembourg accounts for 27% or €235 billion of European ETPs (or much of the non-Irish market); it is the domicile of many international issuers and is seen by many as a gateway for Europe. Luxembourg is also important because it is the largest green stock exchange in Europe; the sustainability sector is anticipated to be a major source of ETP issuance giving growing investor interest in the topic. "Issuers in Luxembourg are aware of the proven efficiency of the international model and many have already begun planning their migrations," says Lermusiaux at Euroclear. These are expected in 2021 once the Irish migration is complete.

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ICSD Makes Sense for Fast-Growing Markets

ETPs such as ETNs, ETCs or 'green' ETFs are in some instances more complex to establish than standard ETFs. However, the benefits of the ICSD model are identical to those enjoyed by ETFs provided they are listed on multiple exchanges. Moreover, non-ETF ETPs are often managed by the same teams and managers as ETPs and have the same purpose (to track various indices, products or strategies). The adoption of the ICSD model by ETCs and ETNs—which currently represent roughly a sixth of the European ETP market[5]—is therefore likely to follow an identical path to ETFs.

There have been some prominent issuances using the ICSD model in recent times, including GraniteShares for ETNs and HANetf for ETCs. "We expect as much as €15 billion of ETC and ETN issuance to adopt the ICSD model in future," says Lermusiaux.

Another market sector where ICSD is expected to become the default settlement structure is green ETFs. While there are currently challenges relating to the lack of a standardised green taxonomy, consumer interest in sustainability has ballooned over the past year across many countries in Europe. Green ETFs are therefore likely to be listed on multiple exchanges and would subsequently benefit from the ICSD structure. Moreover, the international structure can provide greater transparency than the domestic structure, which may be important given the need to ensure that assets referenced in green ETFs are transparent in terms of their sustainability criteria.

For managers with global distribution, the benefits of adopting the ICSD model go beyond Europe. For instance, Euroclear has now connected nine trading venues, including London, Euronext, Moscow and most recently Hong Kong, Israel and Mexico. Further expansion is envisaged in Asia and Latin America. Offering a single international asset class has significant operational benefits for issuers.

[5] https://www.etfstrategy.com/european-etf-assets-break-through-1trn-aum-10339/

Issuer and Regulatory Demands for Transparency

An important additional driver of consolidation and the move to an ICSD model could be the pressing need to improve transparency for both on-and off-exchange ETP activity. As issuers consolidate their offerings, understanding where they are traded and who is holding them becomes paramount. Issuers are therefore taking steps—both on their own and in concert with ICSDs—to further enhance transparency (this was a significant driver of BlackRock's decision to adopt the ICSD model in 2015).

"Today, when a manager issues ETF shares, they get an order from an AP and then deliver to them; the AP then immediately sells those shares to investors in the secondary market. But the only information that the transfer agent can provide to the manager is the name of the AP," explains Allan Stewart, ETF Sales and Relationship Manager at Clearstream Banking Luxembourg. "This opacity is a problem for asset managers who want to understand where their investors are domiciled. Indeed, it is a growing problem as trading moves from on- to off-exchange."

When ETFs are issued via an ICSD issuance model, 100% of the issued shares are held by account holders at the ICSD, adds Stewart. "Gaining visibility over holdings—albeit only at nominee account level—is a major breakthrough for ETF issuers. With transparency comes better and more granular knowledge for issuers and their sales teams regarding where, and by whom, their ETFs are held. With this information, ETF issuers can better target their marketing."

In addition, regulatory requirements around AML and KYC rules are increasingly impacting ETFs and other listed instruments. "Regulatory reporting requires breakdowns of holders and their domiciles (typically if any shareholder's holding is beyond a certain threshold such as 5% of the total outstanding issue size of the ETF)," says Stewart. Given the large number of regulatory initiatives over the past decade, it is expected that the requirements for such information will only increase in the future, providing further impetus for a move to the ICSD model.

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New Mint-Issued ETC Selects ICSD Model

The launch in February of the first ETC by a European sovereign mint, Royal Mint Physical Gold Securities ETC, shone a spotlight on the burgeoning ETC market and the importance of the ICSD model to its growth. The ETC, which was launched in partnership with HANetf as issuer, manager and distributor, is domiciled in Ireland and registered for sale in Finland, Germany, Ireland, Italy, Luxembourg, the Netherlands, and the UK. It reached the $250 million assets under management milestone just two months after launch, becoming one of the fastest growing gold-backed ETCs in Europe.

“The Royal Mint Physical Gold ETC brings the 1,100-year old Royal Mint up-to-date with the best in financial innovation, and physical gold ownership into the 21st century. It reflects the demands of investors for physically-backed assets and ETCs more generally,” says Nik Bienkowski, Founder and Co-CEO of HANetf. “We anticipate interest in the product from multiple European countries and consequently chose the ICSD model, which provides considerable visibility and efficiency benefits for ETCs listed on multiple exchanges.”

BNY Mellon is providing custody, paying agency, settlement agency and common depository services for Royal Mint’s innovative product, which allows investors to redeem their securities for physical gold bars. The ETC uses the ICSD model to facilitate greater efficiency and transparency in relation to issuance and settlement for products listed on multiple exchanges. BNY Mellon services in excess of $3 trillion of assets in the ICSD model.

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“We are one of the few service providers that can act as both a payment agent in the ICSD structure, and as a custodian, transfer agent and fund administrator,” says Tom Ahern, Global Head of Relationship Management for BNY Mellon Corporate Trust.

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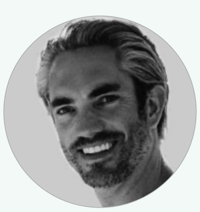

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A Larger, Reshaped European ETP Market

The success of the ETF market is expected to continue as investors increasingly switch from active mutual funds in search of greater efficiency and lower costs. At the same time, the already consolidated European market—the top three issuers represent almost two -thirds of the market[6]—could become more concentrated, according to some observers. “The growing size of the ETP market, combined with the potential for further consolidation, point to increased adoption of the ICSD model across Europe,” says BNY Mellon’s Scappatura.

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Clearstream’s Stewart says that consolidation of the market and uptake of the ICSD is a “two-way process.” He adds: “Adoption of the ICSD model helps drive centralisation of the European ETP market, and in turn a determination by the European ETP market to further centralise itself generates further ETF issuance via the ICSD model. Furthermore, the ICSD model provides issuers with scale effects as they have a streamlined issuance channel to reach a multitude of different markets.”

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[6] https://www.investmenteurope.net/opinion/4002075/spotlight-concentration-promoter-level-european-etf-industry

At the same time, the ICSD model also lowers barriers to entry for smaller boutique-like issuers as it becomes easier for them to tap the potential of a much bigger market. This is likely to be relevant for ETCs, ETNs and especially green ETFs. While these products are expected to grow faster than the market overall, many will (initially at least) be relatively small scale: listing on multiple exchanges in order to benefit from scale should drive managers of these products to favour the ICSD model in relevant markets.

Unsurprisingly, many issuers are currently focused on the migration of their Irish ETPs. Anecdotal evidence, however, suggests that increased awareness of the benefits of ICSD—and a feeling that momentum towards the ICSD model is growing—will ultimately prompt managers across Europe to switch their existing ETPs and issue new funds using the international settlement model. A second wave of ICSD adoption (post-Irish migration) could take place towards the end of 2020 and may last two or three years—a short time given the relatively long history of the ETP market.

90%

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If, as expected, most Luxembourg ETPs adopt the ICSD model, almost 90% of the market will use international settlement. Of course, there will continue to be some niche or purely domestic issuances that will choose to issue domestically. However, these will be marginal: the majority of asset managers have international ambitions for distribution and therefore will seek international structures in order to improve efficiency and broaden their distribution. Within just a few years, a truly pan-European ETP market is likely, with the greater number of products operating on a pan-European cross-exchange basis and the widespread use of a single, centralised issuance and settlement platform for all exchange-traded products.

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1232-ETP Campaign-Whitepaper