THE DEMAND FOR exchange traded funds (ETFs) among European investors is growing, however, it is being curtailed by some of the distribution challenges that exist within the fragmented European market.

In Europe, ETFs are listed in multiple exchanges in different regions and this creates extra complexity and cost on the post-trade side when the ETFs are traded across borders. Trading desks have to hold multiple accounts with all the central securities depositories (CSDs) and follow all the different post-trade practices that exist. This is costly, time-consuming, risky and reduces liquidity. The result is wider spreads for investors in order to compensate their brokers for the extra complexity they incur.

Market participants are looking to have these issues resolved.

Investors see ETFs as more diversified alternatives to direct investment if only the post trade obstacles could be removed.

Investors also want to trade ETFs as an alternative to mutual funds and other actively managed products. They are reluctant to pay managers for alpha that is not always realised and want to trade the ETFs directly on the primary market or over-the-counter (OTC), if only the ETF promoters could make their products more immediately accessible.

International clearing and settlement organisation Clearstream has sought to solve some of these structural obstacles by making ETFs directly available to investors on the primary market. “Distributors are requesting that they use Vestima to trade ETFs,” says Bernard Tancré executive director, head of business solutions at Clearstream. “We have always been able to offer a pipe to the exchange but that involves a broker as an intermediary. What they really want is to be able to trade ETFs directly on the primary market through Vestima.”

In January 2014, it announced that its fund processing platform Vestima would add ETFs to its roster of investment products alongside mutual funds and hedge funds. The first of these was the actively managed Pimco Covered Bond Source Ucits ETF which is available to investors on the primary market. The shares of the Pimco ETF traded on Deutsche Börse are simultaneously available on Vestima at the end-of-day net asset value. “We talked with
promoters about how we could do this,” says Tancré. “Pimco was the first to consider positioning its ETFs on Vestima in order for redemptions and subscriptions to be sent directly to their transfer agent. They recognise the value of having their ETFs available alongside other mutual funds.”

And for investors, they are now able to add ETFs to their range of mutual funds and hedge funds, all of which are available to be traded via Vestima, creating a standard way of processing all their fund transactions.

The plan is to expand the project to include other ETF promoters and Clearstream is in discussion with the likes of Lyxor, Amundi and BlackRock. But while there are a number of promoters that are willing to make their ETFs available via Vestima, many would still prefer to retain their existing authorised participants (APs) as intermediaries in the processing chain, says Tancré.

“They see the value of new distribution models but they want to use their APs as a buffer to manage the excessive inflows or outflows and the transaction cost involved. However, if the promoters want us to continue to work with the APs, that will slow down the project because we have to establish the connectivity and adapt trading mechanisms.”

Another hindrance is that the ETF promoters, while happy to compete with instruments used for direct investment, may not be as keen to see their ETFs competing with their own mutual funds and hedge funds, says Tancré. “They may view it as cannibalistic in the context of their own project range, some of which may have better margins. Therefore they may not have this at the top of their agendas.”

Of greater interest to many ETF promoters is solving the settlement problem in Europe’s multi-listed market. In the past, the major exchanges in Frankfurt and London have tried to solve this by convincing issuers to use only them.

“Every stock exchange could connect to Clearstream in Frankfurt,” says Tancré. “If you trade then settle in Clearstream, you don’t need the ETF administrator to create a separate link to other settlement venues. However it was felt by ETF issuers that this solution was never perfect.”

Instead, the ETF providers and ICSDs have attempted to convince the exchanges to create a special listing for ETFs that can be settled via either of the two ICSDs (Euroclear in Brussels and Clearstream in Luxembourg) rather than the domestic CSDs. One advantage is that the ICSD issuance model is similar to the existing model in place for Eurobonds, so much of the infrastructure already exists. Nor will the ICSD issuance model be undermined but the imminent arrival of Target2Securities, the European Central Bank’s project to provide a single settlement body for all securities in the Eurozone.

“The ICSDs will be integrated into T2S, but it is still at least two years away from going live and that is seen as long term in many people’s view. And T2S only covers mostly the Eurozone. Most ETF providers want to go beyond that and the ICSDs have a greater geographic reach.”

The model is still in its early stages, however. The first issuer involved was BlackRock’s ETF arm iShares, which launched a new ETF range via the ICSD model in June 2013. Since then, says Tancré, the appetite for ICSD issuance has grown.

“It seems to be the new trend. ETF providers like it and we are busy helping them to move their ETF range from their existing issuance and settlement model to the new ICSD-based approach. For those providers interested in this model, I expect them to migrate their entire range over the course of the next year.”

For Tancré and Clearstream, the main task in the next 12 months will be to persuade more ETF promoters to make their products directly available to investors. For those promoters that are keen to solve the settlement issue but more reticent to embrace the Vestima model, it is important to stress that the two are connected and one can lead to the other, says Tancré.

“They are both aimed at achieving the same end – more liquidity and more growth.”