ETFs – the New(ish) Financing paradigm: An Update for 2021

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When I was approached to write an update to the piece I wrote on ETFs three years' ago, I was intrigued to learn just how much had changed over the period and conversely understand what had remained the same. Whilst there is no doubting the incredible impact ETFs have had over the last decade, with AuM doubling over the last five years alone, they have always been peripheral within the confines of Securities Financing in Europe. Either in terms of lending to harness increased yield, borrowing to facilitate short coverage or indeed financing & collateral pledging to fulfil other obligations.

Three years ago I predicted that was about to change: that Europe would emulate the more mature US-market and ETFs were set to play a more mainstream role on the European stage, but was that correct? Sadly, the answer is not clear-cut - both yes & no would be a fair reflection. Therefore, we need to take a more granular look at what has changed for the positive, and where there is still work to do.

Growth Phenomena

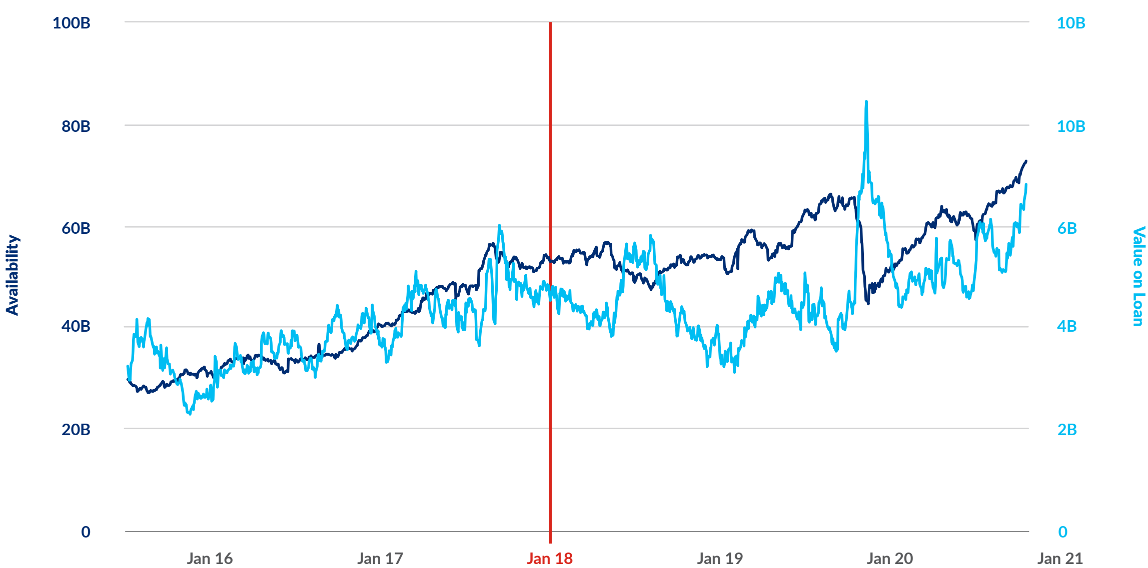
With global AuM over $7 trillion, and Europe comfortably smashing through the $1 trillion mark for the first time ($1.28 trillion by the end of 2020[1]) volumes have exploded. The London Stock Exchange is reporting a 50 per cent increase for 2020[2], demonstrating that ETFs are firmly becoming the Institutional vehicle of choice. Consequently, the traditionally dominant players in the securities lending marketplace (i.e. the largest Beneficial Owners) are unquestionably holding more and more of these products as ETF adoption continues apace.

But are we seeing that translate into increased lending volumes? In simple terms, yes as the table below (courtesy of IHS Markit) shows. In the last three years, we have witnessed an increase in visible availability in Europe of nearly 40% from just under $50 billion then to almost $70 billion now.

Similarly on loan balances, whilst more volatile, have increased from around $4 billion to over $5.2 billion (+30%) and peaked as high as $8.5 billion during the initial Covid 'fallout' illustrating the increasing adoption of ETFs as a macro hedging tool in addition to a core long holding.

[1]Source: Citi ETF Research
[2]Source: London Stock Exchange

Fig 6: Availability and Value on Loan *Source: IHS Markit*



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This compares favourably to last time, when progress was clearly more nascent. However many, if not all, of the previous impediments still remain – nomenclature challenges, multiple sedols (due to cross-listings), classification confusion (is it an equity, is it fixed income?) and perception inaccuracies ("nobody owns them" , "nobody wants them" , "they a retail product") being just some of the most common. The industry can and needs to do more to tackle these, particularly as many of the regulatory challenges and distractions it has had to face over the last few years have largely receded. There surely cannot be too many other opportunities where supply and demand are growing in tandem by 'at least 30%' every three years? If the industry can continue to develop new markets and push into new territories such as Romania, one would hope it could similarly solve for the challenge of having ETFs with multiple sedols?

Fixed Income Adoption

Three years ago, the use of ETFs by Fixed Income investors was still a relatively new occurrence, they appreciated the benefits of going short as well as long, similar instruments, but were often told the market (to borrow) didn't exist. Undeterred hedge funds, and even traditional asset managers, started using ETFs to tactically exploit segments of the market and borrow demand grew steadily. What changed however was the industry reached a tipping point in adoption and ETFs are now an indispensable vehicle for Fixed Income investors both large and small. In fact, through the aftermath of the recent Covid pandemic, it became evident that unlike every previous period of extreme market volatility, fixed income ETFs were no longer the target for criticism. This newfound and welcome credibility will be the catalyst for further growth in use without question.

Additionally the ongoing challenges in settling ETFs on a timely basis, (due to their multi-listed nature) - a particular sensitivity for overseas investors in regions such as Latin America or Asia, has improved greatly by the growing harmonisation of the ICSD model – where irrespective of listing, all ETFs settle in a centralised common depository (Euroclear or Clearstream). Who knew that a little-known piece of Irish legislation – The Migration of Participating Securities Act 2019 – would be a welcome catalyst for European ETF market harmonisation? In addition to improving settlement rates, it ought to drive down market-maker costs, increase risk appetite, and harmonize inventory pools - particularly important in helping grow secondary activities such as options on ETFs, which will in turn fuel further long-term demand. We have already witnessed this in the United States, where an active options market (in particular high-yield fixed income ETFs) has driven demand to nearly 100% utilisation in certain names and generated significant fee income. Interestingly, there are now over 350 ETFs globally where the annualised average lending revenue outweighs the cost of the ETF management fee – a substantial improvement from 2018 when there were 150 such products.[3]

Collateral – Now & Forward Looking

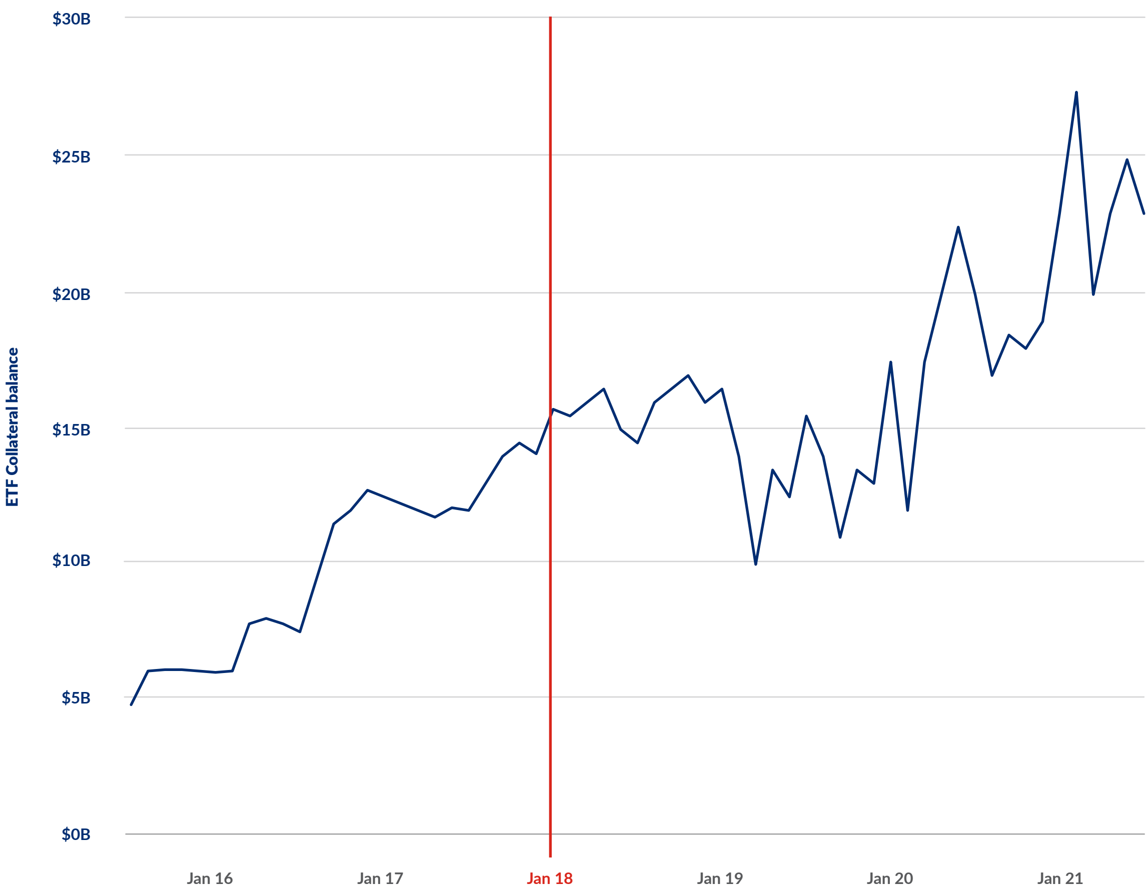
Perhaps now, much like three years ago, the collateral aspect of ETFs has and continues to see the most opportunity and advancement. The desire to pledge ETFs as collateral, particularly in relation to the evolving regulatory environment, is as strong as ever, and put simply, if more and more clients hold them (and in increasing quantities) the need for greater acceptance as a collateral instrument in their own right will only increase. Regulatory change in the form of MiFID II led to much greater transparency on true European ETF trading volumes, where OTC activity had traditionally accounted for upwards of 70% of daily turnover and was largely invisible.

[3]Source: IHS Markit

Greater transparency coupled with inherent in-built diversification makes ETFs an ideal collateral instrument regardless of some of the current hurdles in understanding. The development of industry standard metrics (i.e. , IHS Markit ETF Lists v#1) increased understanding and removed the traditional heavy lifting required in classifying the myriad of ETFs in existence. Consequently, the challenge of knowing which ones to accept and those to avoid in individual and bi-lateral negotiations was a significant step forward. This automated process of pre-approved criteria supported by the tri-party platforms greatly simplified the process and increased speed to market. However, one of the downsides of creating market standardisation was it also naturally limited scope and consequently the initial Lists (one equity, one fixed income) ran to less than 100 ETFs and only grew organically to around 120 in total due to the many inclusion constraints built-in.

However' as the chart below courtesy of BNY Mellon tri-party illustrates, the volumes of ETFs within their European platform is substantial and continues to grow in spite of the limited 'standardised' universe. Over the same three-year period from January 2018, ETF collateral balances have risen by a further 60%, with significant growth in the last 6 months on an ever-increasing trajectory.

Fig 7: BNY Mellon International Tri-Party ETF Balances *Source: BNY Mellon*



Although the initial Markit Lists created industry-wide harmonization for the first time, the very nature of that standardization, limited growth considerably. To satisfy demand for more securities and to allow for a degree of flexibility & customization, Markit are about to launch Lists v#2 which will radically increase the number of eligible ETFs.

Whilst continuing to support the first generation product, this new offering will have 'Overlap Scores' based on empirical analysis of holdings using the daily ETF Portfolio Composition Files – this in turn allows for a slight deviation away from the big brand indices and creates a much broader pool of inventory. Custom Lists allowing profiles to be specific to Collateral Receivers risk mandates and eligibility criteria will further broaden the universe, such that it is not inconceivable that a particular Lender's List in future may run into the thousands of ETFs rather than the low hundreds. This will undoubtedly have a significant positive affect when it comes to increased usage of ETFs as collateral.

Parallel Opportunities?

What the Markit ETF Lists unquestionably do, is bring clarity & classification to a product that the marketplace has historically found challenging. There is no evidence to suggest that the inability to bring ETFs into the mainstream was down to mistrust or lack of interest, rather the inability to cope with a product that did not adhere to the norms of the single security environment. What is interesting is how these recent advances in understanding, and more importantly tools to accommodate, could be relevant for another seismic change about to sweep the industry : ESG. There are huge parallels in the current explosion in interest in ESG products with ETFs. Both are irreversible trends that are set to dominate the investor landscape and have come to symbolise the rise of the millennial investor.

Therefore, the imminent requirement for the securities finance industry to adapt to increasing ESG constraints could benefit from a similar approach adopted by ETFs, particularly as the ETF industry is leading the way in ESG conversion and adoption.

More To Do

Now as in 2018, there is still much to do. What has become evident over the last couple of years is the continuing lack of 'ownership' within the securities finance industry itself. Rather it is being largely supported by a small band of enthusiasts who are more often than not peripherally involved through their involvement in the ETF industry.

I put myself firmly in this category by definition. Now is the time for industry practitioners to rise to the challenge, and to resource and prioritise this opportunity appropriately. This is particularly relevant when so many of the industry's heavyweights generate so much revenue from the product itself.

Illustrious names in securities finance such as State Street, Bank of New York, Brown Brothers Harriman, Northern Trust, BlackRock and J. P. Morgan - to name but half a dozen are also the top names in the ETF industry, either as issuers or custodians, and often both.

It cannot surely be too long before their clients and their colleagues become more vocal to the missed opportunities?

With global AuM forecast to hit $12 trillion in the next few year, ETF numbers on-loan or pledged as collateral are still modest at best. Many major lenders are still unable to unlock their full inventory, being unable to identify them in their custody system or overcome the multiple sedol challenge.

More often than not, misconceptions persist about the lack of appetite to borrow, and the consequent lack of prioritisation depletes availability feeds and dampens enthusiasm yet further. Unsurprisingly prime brokers have historically been uncomfortable indicating stable supply to hedge fund customers that in turn ultimately stifles potential demand, creating a vicious circle of inactivity.

Similarly, reliance on only on-exchange volume data, (which vastly under emphasises the true secondary market liquidity), results in a skewed impression, particularly in combination with traditional 'single stock' practices, such as average trading volume constraints that are inappropriate for open-ended funds.

Looking back to a previous example, at the end of January 2018, a leading UCITS FTSE100 ETF reported 1.6 million units traded on the London Stock Exchange[4], but a further 12.2 million recorded under MiFID II reporting, giving a true picture of 13.8 million shares that traded. Looking at the same ETF on 11 November 2020, the on-screen liquidity had grown to 22.1 million units, and the entire traded volume that day was an impressive 89.8 million units, or over 'half-a-billion sterling' in notional terms. Contrast this with a well-known stock such as HSBC, the third largest constituent in the FTSE100, which only traded 38 million shares that day, worth a total of £150 million in comparison.

This is a testament to how relevant and liquid ETFs have become and yet it is still not lent as 'GC' nor readily taken as collateral?

Notwithstanding these challenges and issues, demand and interest drives change and therefore, regardless of which side of the lending, borrowing or collateral pledging or receiving conundrum your firm sits on, being more vocal and 'owning' change is key to resolving these last hurdles and bringing ETFs fully into the mainstream for securities finance.

With the impending implementation of CSDR and the yet unknown implication for ETFs, there could be a very real upsurge in demand to prevent punitive penalty charges and buy-ins, resulting in further revenue growth for the industry and opportunities for clients.

Opportunities like these outside North America are growing swiftly for ETFs and in line with the wrapper itself and consequently now is the time to help build a more efficient lending market for ETFs and ensure significant new revenues are not missed. The challenge is on!

[4]Source: Bloomberg

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Andrew is a Managing Director and Global Head of ETF Product at Citi.

In his role he is responsible for leveraging Citi's global network across divisions and asset classes to align processes and outputs in all regions and work alongside underlying products and support functions to drive global excellence as it pertains to ETFs.

This includes the build-out of their Fixed Income and Currency Beta platform, the development of an ETF Custody and Fund Administration business, the enhancement of Citi's Issuer Swap platform, the evolution of Funding, Capital Treatment and Collateral framework for ETFs and all Legal, Technology and Operational advances.

Furthermore the role provides a key resource for the regional Sales and Distribution teams and he serves on Citi's global ETF Steering Committee.

Previously Andrew was Managing Director and Global Head of Broker-Dealer and Market-Maker Relationships for BlackRock's iShares ETF business and is a regular contributor to both print and digital media for leading global publications and speaker at industry conferences and events.