Exchange Traded Funds in Europe - The Way Forward (Part II)

CORMAC COMMINS reflects on the past 16 years of ETFs in Europe, how the environment for ETFs has evolved Europe and looks at what can be done to increase flows into European ETFs.

Nearly sixteen years ago, in August 2002, I penned an article for this publication entitled 'Exchange Traded Funds in Europe - The Way Forward'. The article noted what was, at that time, a period of considerable growth for exchange traded funds (ETFs), with global ETF assets totalling $112.5 billion. The US was identified as the leading market for ETFs having experienced very strong asset growth, with ETF assets growing from $15 billion at the end of 1998, to $88.6 billion by the end of the first quarter of 2002.

At that time, ETFs in Europe were still in their infancy, with the very first European ETFs domiciled in Ireland, and the article referenced the rate of growth in European ETFs since they were first launched in Europe two years earlier, compared to the growth rate in the US. Over the first two years of their existence in Europe, the number of ETFs had grown from 2 to 92 and was bridging the gap between the number of US ETFs which at that time stood at 112. However, asset gathering was much slower in Europe, with assets under management in European ETFs standing at $6.9 billion, or only 8% of the US market, at the end of the first quarter of 2002.

The article sought to examine the environment for ETFs on both sides of the Atlantic and to identify some reasons for this slower rate of asset growth in Europe. It was even bold enough to suggest some changes to the environment in which ETFs in Europe operated, if the growth rates which ETFs had experienced in the US were to be replicated in Europe.

Among the factors highlighted in 2002 was the fact that the US was a single market with a single currency, all US ETFs were regulated by a single regulator, and most US ETFs were listed on one exchange, what was then the American Stock Exchange (AMEX).

In contrast, Europe's fragmented market with multiple currencies (notwithstanding the introduction of the euro a few years earlier) and varied distribution models across different countries limited full cross border investment, in particular at retail level. As the early European ETFs were structured as UCITS, the UCITS cross border registration process which existed at the time, which was inconsistent across Member States and a very time consuming process, was also seen as a hindrance to ETF growth. Another factor proffered for this slower growth was the lack of a single European listing platform on which all European ETFs could be listed.

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Some suggested changes to the European ETF market put forward in the article included improvements to the cross border registration process, the creation of a single European listing platform and increased awareness amongst investors of the benefits of ETFs as an easily accessible, flexible and low cost means of gaining exposure to the markets.

So how has the environment for ETFs changed over the past sixteen years and have any of the perceived impediments to their growth in Europe identified back in 2002 been addressed?

As the majority of European based ETFs are authorised as UCITS funds, changes introduced in 2011 to simplify the UCITS cross border registration process has made the process a far more efficient one, greatly reducing the time and costs involved. While no single centralised exchange operates in Europe, the cross listing process has been simplified for some leading ETF exchanges with admission to trading on the exchange permitted with minimal requirements, where the ETF is listed on another European exchange. One of Europe's leading ETF exchanges, Euronext, has also broadened its multi-jurisdictional coverage providing a pan-European ETF listing platform now covering six key European centres. The development of a centralised European settlement system has also greatly improved the ETF settlement process, removing the requirement for traded ETF shares to settle in the local market in which they are listed, thus removing the requirement for shares to be moved from one market to another to satisfy an issuer's inventory requirements on another exchange - a complex and inefficient process.

So while some of the structural deficiencies which had existed in the European market have been addressed, Europe still today lags behind the US on the asset gathering side. While the number of ETFs in both markets is broadly the same, 1,876 in the US with 1,634 in Europe as at February 2018, the aggregate asset size of European ETFs at $791 billion represents only 23% of the US market which stands at $3.4 trillion for the same period.

So what steps are being, and can be, taken to increase flows into European ETFs?

The development of factor based and actively managed products to complement the traditional capitalisation weighted based ETFs is providing investors with greater product choice and increasing their appeal. Demand for low cost, transparent products driven by regulatory and investor focus on fund costs positions ETFs nicely to satisfy that demand. Advances in technology will continue to drive efficiencies in the development and running of ETFs, as well as powering distribution channels in areas such as automated advice and will have a significant influence on ETF growth. More education and greater awareness amongst investors of the benefits of ETFs, in particular amongst retail investors, where take up is much lower in Europe than in the US, a factor relevant in 2002 is equally as relevant today. More work is required on this front. However, with ETF penetration representing only around 5% of European fund assets, there is without question considerable scope for further growth in Europe.

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