EUROPE’S ETF ECOSYSTEM: THE ROAD AHEAD

Experts from every corner of the exchange traded industry discuss where it goes from here.
In the natural world every organism has its own role to play in creating a healthy and diverse ecosystem.

Within this system, complex interactions between living things and the atmosphere take place to create the energy needed to sustain life.

In the financial world there are of course parallels. A healthy asset management industry relies on a series of co-dependencies. Investors, managers, regulators, brokers, custodians, data providers, lawyers, platforms and distributors; all play a part in keeping investment markets functioning effectively.

However, evolving and emerging external factors such as innovation, technology and regulation are disrupting the balance of this long-established ecosystem.

While no industry is immune from the rapid advancement of technology and the changing business economics associated with it, asset management stands out as one steeped in very human traditions.

Building trust, maintaining relationships and delivering investment returns - these were the foundations strong asset classes; ETFs tick a number of key regulatory boxes and for many strategies, can be a better delivery mechanism than the traditional mutual fund. Mutual Fund 2.0 if you like.

Importantly and contrary to popular belief, ETF does not equal passive. ETFs are being used to deliver both active and passive strategies.

The penetration of ETFs in the European retail market will be a key driver of future growth. MiFID II will provide significant tailwinds for ETFs across Europe, supporting a level playing field for retail distribution and providing more transparency around the true liquidity of ETFs.

In the US, there is an even split between institutional and retail assets. In Europe, the ETF retail market is small because of the commission based business models that developed pre MiFID II. As IFAs and wealth managers adjust to the ban on inducements and look to deliver value through fee based models, ETFs will become ever more prevalent in retail investor portfolios.

The establishment of robo-advice firms exclusively using ETFs as portfolio building blocks in Europe gives an important insight into the direction of travel for the retail advice market and the opportunity to target the mass-market and mass-affluent segments open to disruptive technologies.
‘It is KPMG’s view that most asset managers will have an ETF offering in the future, using the technology to revitalise their product range and open up new distribution channels. ETFs will be viewed simply as a better delivery mechanism for their strategies; not as a stand-alone business.’

- Tim West, KPMG in the UK

Regulators will continue to play a key part in the development of the ETF story. Broad acceptance of non-transparent active ETFs and exchange traded share classes of existing mutual funds are two key potential developments that would support the growth of the industry and provide investors with access to a whole new range of investment strategies through an ETF wrapper.

The line between traditional service provider and issuer activities is now blurring as providers invest to compete. As such, internal builds can be minimised and existing manager functions can support the oversight requirements.

Asset managers put off by the historical cost of developing an ETF capability should revisit these assumptions and explore the many different ways of providing client access to their strategies through the ETF wrapper.

It is true that there are still some key inefficiencies in the European market that need to be resolved to fully support the ETF success story, however, we are starting to see the ecosystem come together to fix these problems. In many ways the growth of ETFs is necessitating that these inefficiencies are being addressed, benefiting not just ETFs, but the industry as a whole.

Assets invested in European-listed ETFs and products is expected to exceed $1 trillion in 2018¹. Predictions around future growth are contingent on a number of variables, but if ETFs continue to grow at their current pace in Europe assets will more than double in the next five years.

The fact that European ETFs currently only account for 5% of the funds market, coupled with their potential for disruption, leads us to believe that the asset gathering opportunity is even greater².

It is with this potential in mind that KPMG invited key players from across the ETF ecosystem to discuss how they are positioning themselves to support the growth of the ETF market.

From regulation, to innovation, to education – leading practitioners delivered their expert opinion throughout an engaging roundtable discussion held in London in spring 2018.

This report seeks to highlight some of the key issues raised in the debate. We hope these expert interactions provide valuable insight into the growth of Europe’s ETF industry, wherever in the ecosystem you and your business sit.
1. Marc Knowles  
Consultant on ETFs,  
KPMG in the UK

2. Phil Beattie  
EMEA Head of ETF and Indexed Fund Licensing,  
MSCI

3. Ciarán Fitzpatrick  
Head of European ETF Servicing,  
State Street Global Services

4. Paul Heffernan  
Head of Cross Border Sales,  
HSBC Security Services Europe

5. John Keogh  
Managing Director,  
Susquehanna International Securities

6. Axel Lomholt  
Head of Europe Product Development,  
Vanguard Asset Management

7. Tara O’Reilly  
Co-head of Asset Management,  
Arthur Cox

8. Bill Vasilieff  
CEO and Founder,  
Novia

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ETFs have experienced phenomenal growth in recent years, but ‘old school’ business models, market fragmentation and distribution challenges have all been cited as constraints to ETF growth in Europe, can MiFID II fix this? In this chapter our expert panel share their on the ground perspective.

David Abner wrote the book on ETFs, the actual book. Having penned the first technical guide to ETFs for professional advisers the American WisdomTree exec is in no doubt over what’s standing in the way of faster and more widespread ETF take-up.

‘The real reason we haven’t seen faster adoption of Exchange Traded Products (ETPs) in Europe, and this is also applicable in the US, is because of the protection of old-school business models,’ he said cutting quickly to the chase at KPMG’s roundtable in London.

‘Firms don’t want to give up revenue streams to move people into lower fee, more transparent products.’

Axel Lomholt, head of product development for Europe at Vanguard Asset Management, pointed to the structure of the European market as another explanation.

Markets outside the US, particularly Europe, Lomholt added, suffer from fragmentation with different jurisdictions, multiple currencies, numerous Exchange listings and post-trade complexity.

However, he was keen to point out what he believed to be a ‘transformational shift’ in investor attitudes to ETFs as a result of MiFID II regulation.

The main thrust of the regulation, which came into effect on January 3rd this year, is consumer protection. For smaller scale players, such as wealth managers, it has increased the cost of servicing clients as technology solutions have had to be implemented to comply with new rules on inducements, transparency and transaction data.

‘This is a great tailwind for European ETFs because these products blend extremely well with low-cost active advice solutions, such as model portfolios and scaled investment advice,’ Lomholt said.

There are themes in regulation around transparency, value and low cost that echo strongly with ETFs.

Phil Beattie, EMEA head of ETF and indexed fund licensing at MSCI, noted that although the European market was smaller than the US, it has grown at a similar pace and as the challenges around distribution, fragmentation and post-trade complexity are addressed, the European ETF opportunity will really open up.
Learning from past experience

However, it was noted that regulatory change is not always immediate in realising its objectives. Tara O’Reilly is co-head of asset management at Dublin-based law firm Arthur Cox. She has been involved in the structuring of ETFs for many years and offered a more circumspect appraisal of growth predictions.

While she accepted that MiFID II changes to the way advice is paid for will drive more investment towards passive products, she drew parallels with the RDR experience in the UK, which was a slow and gradual process.

Where O’Reilly did see potential for swifter progress was in respect to platforms. ‘Many do not currently offer ETFs. Regulators are looking to see if platforms are providing value for money and meeting investor expectations, which may drive a push, to actually include ETFs.’

Excuses, excuses

Here Bill Vasilieff, CEO and founder of Novia, a platform which counts its technological capabilities among its USPs, concurred.

‘The reason platforms can’t handle ETFs is that they weren’t built to handle them.’

- Bill Vasilieff, Novia

Vasilieff said that despite an ‘astonishing’ amount of money being spent across the platform industry to upgrade infrastructure to facilitate ETF trading, much of the build out has been ineffective and as a result penetration among IFAs is still extremely low.

Novia chief Vasilieff used the proliferation of robo-advisers, which like his own firm have been set up to trade ETFs from day one, as a further example of progress.

‘If you think it through and build it, it’s possible, so this is not a technology problem.’

WisdomTree’s Abner agreed that while technology has in the past been blamed for a lack of access to ETFs, it was not ‘a reasonable excuse any more’.

He was equally on-board with robo-advice’s potential, predicting in the long term, particularly in Europe, that these investment services would likely have a significant impact on how the wealth management industry operates and fuel demand for exchange traded products.

‘We expect faster adoption in the use of robo-advisers in Europe than in the US, almost similarly to the way people in emerging markets skipped using land lines and went straight to mobile,’ he said.

Adding: ‘At the heart of robo-advice is lower costs for the end client. ETPs are facilitated easily by this technology and we believe the flexible use of these products for efficient portfolio allocation will lead to increased adoption of ETPs.’

Commenting on the true impact of MiFID II, John Keogh, MD Susquehanna, questioned whether it had done anything to reduce fragmentation of trading and improve on-exchange liquidity. Keogh commented, ‘If you had a trading obligation for ETFs, you might get more concentration on particular venues, as opposed to now, where we’ve still got Systematic Internalisers (SIs) and the OTC market.’
‘We expect faster adoption in the use of robo-advisers in Europe than in the US, almost similarly to the way people in emerging markets skipped using land lines and went straight to mobile.’

- David Abner, WisdomTree

Tara O’Reilly, raised a further issue in terms of MiFID II immediacy in relation to the lack of a consolidated tape as seen in the US. Whilst all ETF trades are now reported, they are reported to different places, in different formats making it difficult to assess the true liquidity of ETFs.

Armed with a holistic view of the growth dynamics for ETFs, Mark Knowles, consultant on ETFs at KPMG in the UK, pointed out that not only will regulation support existing issuers in the distribution of their products, it will also attract new types of ETF issuers. Knowles is talking to asset managers seeking clarity from regulators around the suitability of non-transparent active ETFs and exchange traded share classes of existing mutual funds. Clear and supportive guidelines on these two points are likely to stimulate a lot of interest in the ETF wrapper from traditional active managers.

In the past, he says that asset managers have viewed ETFs as a standalone business decision, and as such why bother and compete with the established players? However, managers now realise that ETFs can be a better delivery vehicle for their strategies – active, passive and anything in-between.

‘There is a growing realisation that ETFs are not just for index tracking strategies. KPMG member firms are working with a number of traditional active asset managers assessing the ETF opportunity.’

- Marc Knowles, KPMG in the UK
WHAT IS THE IMPACT OF INCREASED INNOVATION?

Smart Beta, fixed income and ESG; a whole new breed of ETF products are hitting the market to cater to a multitude of investor tastes. In this chapter the panel debate whether it’s a field of dreams, or a step too far.

Computing power is increasing year by year, its by-product: massive amounts of data. Data that asset managers can use to create new products.

But to not just survive, but thrive in the data era, differentiation is key.

Innovative product development in the form of Smart Beta as well as fixed income and ESG solutions are emerging as significant industry trends with the potential to really move the needle in terms of asset growth for the European ETF market.

‘It’s near impossible to talk about the growth of the ETF industry without mentioning “Smart Beta”, said KPMG in the UK’s Marc Knowles.

At its most basic level, Smart Beta is the term used for a series of strategies that serve as an alternative to traditional market capitalisation indices.

Knowles argued that transparency and education will be key to its future success, as the term captures many different approaches and methodologies behind a very diverse segment of the ETF universe.

Lawyer Tara O’Reilly said that as regulators look at more innovation across the industry, the question arises as to whether an ETF wrapper is appropriate.

Meeting investors’ expectations

‘ETFs historically have been sold on the basis that they are simple, transparent and liquid. So yes, you can do it as a UCITS, but are we clear in our description? Is it going to meet investor’s expectations?’ Tara O’Reilly agreed that investor education and proper disclosure will be key in this respect.

State Street is investing heavily in its ETF servicing capability, Ciarán Fitzpatrick is head of ETF servicing for State Street Global Services across Europe, he explained how the firm was gaining an edge in what has become a competitive marketplace by anticipating what the industry needs in terms of infrastructure to comply with regulation and support further innovation and growth: ‘There are a lot of other asset servicers entering the market, or who have been in the

‘We’re trying to change the ETF market and make sure it is moving to where it should be in 10, 15 years’ time’.

- Ciarán Fitzpatrick, State Street Global Services

market and are trying to grow in that space, knowing that the business is going to grow. So we’re dedicating significant funding into developing what the market requires.’

‘At the moment, we’re discussing with the authorised participants and our issuers about developing centralised ETF technology in the European and global market.’

Deliverables, Fitzpatrick explained, are still sent via email, with contract notes in different file formats. If the industry is to grow as it has the potential to, this needs to change.
'We’re trying to move to the next level from a technology standpoint and build machine readable, up-to-date formats. This isn’t just for State Street or the issuers we work with, we’re trying to change the ETF market and make sure it is moving to where it should be in ten, 15 years’ time.'

Phil Beattie, MSCI, has the advantage of seeing demand across the whole of the ecosystem from the biggest asset owners, all the way down through to funds and ETFs.

**Environmental, social and governance (ESG) criteria**

In recent years he has seen a huge movement in ESG index investing, and not just across equities.

‘The UK pensions regulator has now said that you must consider all financial risk pertaining to ESG as part of your fiduciary duty. Now, if you’re doing that, there’s nothing there that says it must just be in equities, it’s not asset class specific.’

This explains MSCI’s recent partnership with Bloomberg Barclays to leverage its ESG research capability to build fixed income indices.

WisdomTree’s David Abner too was enthused by what he perceived to be a significant change in mind-set when it comes to sustainability.

‘It’s a lifestyle transition, as opposed to an investment decision’.

Agreeing with MSCI’s Beattie he predicted that ESG investing is set to become a very big component of overall investment portfolios, no longer resigned to a specific, or niche segment.

‘The UK pensions regulator has now said that you must consider all financial risk pertaining to ESG as part of your fiduciary duty.’

- Phil Beattie, MSCI

HSBC’s Heffernan was on the same page, however he said defining exactly what classifies ESG was an important first step.

‘There’s a lot that needs to be done to bring consistency of understanding, or ESG standardisation to the industry so investors can make meaningful comparisons and really understand their ESG related investment decisions.’

In contrast, Vanguard’s Lomholt was excited by the stellar progress made in ESG performance to date.
‘There’s a lot that needs to be done to bring consistency of understanding, or ESG standardisation to the industry so investors can make meaningful comparisons.’

- Paul Heffernan, HSBC

‘Over time what has been holding back investment into ESG is this whole thing about whether it delivers you a better return than the ordinary benchmark. The good news is that ESG returns are no worse off than the mainstream benchmark.’

‘This, in its own right, is a huge shift in how asset owners and asset managers are thinking about ESG.’

Another area of growth is fixed income, Lomholt argued that a huge opportunity exists to ‘democratise’ the asset class, a process already underway in equities.

Fixated on fixed income

‘Retail investors can now buy all sorts of fixed income exposures in a simple transaction. It is mindboggling. What’s more, for some bond ETFs secondary market liquidity is better than liquidity in the underlying index as many investors opt for trading in the secondary market rather than in the primary market.’ Throwing a little more caution into the mix was market maker Keogh, while he agreed growth would come from bond ETFs, he wanted to see the underlying market improve in terms of efficiency and transparency.

‘We now have order books for equities and ETFs, but you still have a quote driven market in the fixed income underlying market.’

‘There are access issues still, closed dealer groups and indicative pricing, and so I’d really like to see that market become more electronic and order driven, because I do worry, without that level of efficiency in the underlying market, the price formation process in ETFs can be compromised and the liquidity in the underlying instruments, that they partially rely on, could be too.’

‘I think that’s a challenge for regulators and for the industry as a whole.’

It is precisely these shortcomings in the underlying bond market, however, that convince WisdomTree’s Abner of the fixed income market’s ETF potential.

‘Certainly it is set to be one of the biggest drivers of growth in the industry in its next phase,’ he said.

Adding: ‘Its size and lack of transparency mean ETFs can offer solutions to a number of investor challenges in one go, which is exactly what a financial product needs to do in order to generate meaningful flows.’

Coming to market with such a solution requires a carefully thought out distribution plan. However this is often the missing link for many new entrants, remarked KPMG’s Knowles.

Distribution disarray

Knowles commented that effective distribution is undoubtedly one of the key challenges faced by new ETF issuers. Some new ETF entrants have struggled to motivate sales people to sell passive ETFs, which has resulted in them burning down seed capital and struggling to raise subsequent assets.

However, this challenge relates to differences in the active versus passive sales approach; rather than the ETF wrapper itself. He believes that new issuers wrapping existing active strategies in an ETF structure will not be challenged to the same extent.

‘We now have order books for equities and ETFs, but you still have a quote driven market in the fixed income underlying market.’

- John Keogh, Susquehanna International Securities
KPMG works with asset managers to help them implement the right ETF distribution strategies. Knowles said the most suitable strategy can differ from firm to firm, there’s no one size fits all approach. What’s clear is that managers that take the time to understand the needs of their target clients, develop the right products at the right price and implement an effective distribution and marketing plan way ahead of launch, set themselves up best for success.

Distribution plans are also coming under increased scrutiny from regulators. Arthur Cox’s O’Reilly explained that questions are now being asked over whether a product is creating complexities and whether there is a cost benefit attached.

‘As a result I think there’s much more focus on directors being able to respond and explain the distribution strategy to regulators in terms of the decisions that they’ve made.’

Market maker Keogh too would welcome a move away from what he described as a ‘field of dreams’ approach to issuance.

‘You need a big sales force and boots on the ground in Europe, I think, more than any other territory, to make those new products take off and that’s certainly what I look at when I talk to issuers. I just wonder, what distribution effort are you putting behind it?’

‘It needs more than a “build it and they will come” attitude.’

‘Retail investors can now buy all sorts of fixed income exposures in a simple transaction. It is mindboggling.’

- Axel Lomholt, Vanguard Asset Management

An eye on the future

Hope, they say, is not a strategy - which is where Vanguard’s Lomholt believes standard setters such as the International Organisation of Securities Commission comes in. Leveraging IOSCO’s collaboration with the G20 and the Financial Stability Board, Lomholt argues will open the door to meaningful progress in the development of Europe’s ETF industry.

‘I think there is an opportunity for us, as an industry, to agree on the three or four major issues that impact the entire ETF ecosystem and educate regulators on these important issues,’ he said.

While the other members of the panel were looking forward, Susquehanna’s Keogh took a moment to look back for innovation inspiration. He used the creation of the Dutch options market as an example of how exchanges can play a pivotal role in initiating and building trade.
‘There was a lot of work done in the 1980s by the Dutch Amsterdam exchange to educate Dutch investors about the uses of options. That market now stands out in Europe as a great options market with a range of investors participating.’

Looking forward, State Street’s Fitzpatrick commented, ‘From a market making perspective, when we look into the future, what we’re hoping for is that the regulatory changes that happen in terms of increased transparency, unbundling of fees, a bigger focus on best execution, are going to move us to a world where best price wins.’

**A lesson in education**

Education too was high up on HSBC’s Heffernan’s agenda. ‘Relative to the US, in Europe we’re still a reasonably small industry, we need to bring more people into it. We need to engage a wider community of retail and professional investors. We need to spread the word. Everybody in the ETF ecosystem has that responsibility.’

For MSCI’s Beattie, the education process should start with a clearer communication of terminology. ‘There’s a broad misunderstanding of what passive and active mean in the marketplace. For instance if you buy a factor strategy, the fact that it is implemented via an index, it’s still an active decision to choose that exposure. So that’s one thing we can do better; educate people around what is active, what is passive.’

Backing this up in more detail came lawyer O’Reilly, who said, ‘There is a direct legal responsibility from an issuer’s perspective to the people who buy that product, and so care must be taken in terms of the description of the product in its offering document.’

‘There’s much more focus on directors being able to respond and explain the distribution strategy to regulators.’

- Tara O’Reilly, Arthur Cox

**A new age**

Moving beyond technical descriptions WisdomTree’s Abner closed out the session in positive fashion, arguing we are in fact in the midst of a ‘golden age’ for investors. ‘Fees are down on investment products, 80%-90% over time. For a new investor coming in now, their 30-year outcome is going to be far superior than it might have been 30 years ago, and we see fees on investment management dramatically reduced.’

But the industry, he concluded, will continue to see rapid change; in regulation, distribution and technology.
‘We must educate investors and address their challenges to ensure they can capitalise on the opportunities that are available to them. This is particularly pertinent when discussing the retail sector and ensuring further penetration in the coming years.’

- David Abner, WisdomTree

WHERE DO WE GO FROM HERE?

The traditional asset management industry is at an inflection point, old-school business models need to change and make way for new approaches. Here’s a recap on how our expert panel see that shift unfolding.

**Regulation**
- MIFID II provides a strong tailwind for ETF growth; but is not a silver bullet. Expect gradual change like in the UK after RDR
  - The development of a ‘consolidated tape’ is needed to realise the MIFID II ambition around post-trade transparency
- Pending approval of non-transparent active ETFs and ETF share classes has the potential to significantly spur growth and the number of new entrants
- Reform engagement with regulators should be targeted and outcome oriented. The industry needs to align on the key outcomes and educate collectively

**Innovation**
- DFM and Robo-advice firms using ETFs as portfolio building blocks indicate the future travel of the retail market and the significant opportunity for ETF growth
- Fixed income is the next ETF frontier, but quote driven underlying market inefficient
- Huge shift in investors’ mind-sets towards ESG, but standard classifications needs to be developed

**Education**
- ETFs issuers need to understand their distribution strategy and expect to explain it to regulators
- Study the Dutch – their options market education in the 80’s led to a vibrant marketplace
- The industry as a whole needs to better educate the ETF market broadly on the benefits of ETFs and more specifically around how they should be selected
**HOW KPMG’S ETF PRACTICE CAN HELP**

As the ETF space continues to grow in size and complexity, it’s more important than ever to work with the right business adviser. KPMG ETF professionals understand the interconnected relationships across the ETF ecosystem and is working with global clients across the industry to position them for success every step of the way.

**ETF issuers:** KPMG ETF professionals work with ETF issuers to develop strategies and help implement change, providing guidance on major developments such as Brexit and MiFID II. Teams can also advise on ETF issuer acquisition strategies, business integration, and third-party service provider selection and due-diligence.

**New issuers:** Regulatory scrutiny and disruptive innovation necessitates that asset managers revisit and realign their business models and product ranges. ETFs tick a number of key regulatory boxes and open up new distribution channels. Importantly ETFs can be used to deliver both passive and active strategies, and can be a better delivery mechanism than the traditional mutual fund. KPMG member firms work with asset managers to develop and implement the most appropriate and effective ETF strategies for their business.

**Service providers:** ETF assets are serviced by a wide range of service providers that are likely to benefit from the explosion in ETF assets. “Best in class” service providers that continually invest to deliver innovative and efficient ETF services will reap the rewards. KPMG ETF professionals help service providers understand what “best-in-class” looks like now, and in the future. KPMG member firms help clients develop and implement ETF strategies which are designed to enable success.

**Distributors:** Clients including banks, market makers, exchanges and platforms will benefit from increased flow of ETF assets between investors. KPMG member firms work with clients to position them for the emerging opportunities and challenges ahead.

**Regulators:** Across the globe, regulators are focused on ensuring that they understand investor benefits and risks amid ETF market growth. Regulation will have a fundamental impact on industry growth and KPMG member firms work with regulators as independent advisors on topics such as market structure and non-transparent active ETFs.

**Taxation:** “Responsible tax” is critical for investment management and ETFs. KPMG investment management tax teams have significant experience advising ETFs and as a result can assist with a wide range of tax issues in relation to the treatment and obligations of the fund, its investors, its manager or in relation to the investment return which it earns. Issues which commonly require tax input include VAT advice on establishment, investor taxation reporting, withholding tax management, tax documentation completion and ongoing compliance (e.g. VAT, FATCA, CRS, etc.).
Regulation will have a fundamental impact on industry growth.

About KPMG

KPMG has long been recognized as a leading provider to the financial services industry, serving companies globally. Through the KPMG global network of member firms, there are more than 2,700 partners and almost 39,000 professionals offering global financial services across 115 jurisdictions in some of the world’s most-prominent financial centres.
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