ETFs As Collateral
The Results
ETFs as collateral: are they your funding friend?

Why are ETFs growing in Europe but their use as collateral in securities lending is not? A Securities Lending Times and Markit survey reveals what the market is thinking right now, and how the use of ETFs as collateral can grow in the future.
In this new world of collateralisation, securities lending is an old hand. Beneficial owners across the globe calculate risk against reward, and the indemnity their agent lenders can obtain from borrowers on their behalf is an important figure in that calculation. If the reward outweights the risk, deals can be done. If that risk is too great, the beneficial owner will seek a borrower elsewhere.

The forms that this indemnification can take are myriad and complicated, each with its own pluses and minuses that weigh differently on the minds of the individuals concerned. Indemnification is subjective—what is wrong for one beneficial owner might be right for another.

The exchange-traded fund (ETF) is a form of collateral that is growing in stature, particularly in the US and Europe. According to Markit, the global exchange-traded product (ETP) industry stands slightly below $3 trillion in assets under management (AUM), after growth of more than 16 percent in 2014, with Europe contributing inflows of more than $61 billion and the US contributing inflows of more than $240 billion. Forecasts anticipate global AUM to more than double over the next five years, with Europe being an important driver of that growth. European assets are less than a quarter of US assets, although net inflow growth in European assets, relative to the size of the region, was higher in 2014 and continues to be higher in 2015.

Drilling down in to ETFs, Europe is catching up with the US. Markit ETF data show the US market is currently four times the size of Europe, and the reported turnover in US ETFs is seven times higher than the Europe, Middle East and Africa (EMEA) region. But growth in the US ETF market is starting to flatten, as inflows in the EMEA region grow faster than they do in the US. So, the US appears to have peaked, but Europe is working to catch up. Indeed, Markit notes that the EMEA has almost double the number of exchange-traded products of the US, while its bid/ask spread is approximately 50 percent higher than in the US on average.

It surprising, then, to see that as US ETF lendable value increases in line with AUM growth, the EMEA region is declining in lendable value, despite the growth of inflows. There has also been growth in non-cash collateral being posted for ETFs in the US recently, and utilisation in the EMEA is below 5 percent compared to 20 percent in the US. Why are ETFs growing in Europe but their use as collateral in securities lending is not?

A Securities Lending Times and Markit survey of 66 professionals who work in securities lending in some capacity revealed that liquidity is the most important consideration to them when deciding what to accept or post as collateral, outpacing cost and risk weighting by some margin. When they were asked whether they accept or post ETFs as collateral, the majority of respondents who are located in Europe were split, with slightly more saying they accept or post ETFs as collateral than those who said they do not. The response from those located in North America was equally close.

Today, less than 5 percent of ETFs in Europe are used for lending compared with an estimated 25 to 30 percent in the US, says Andrew Howieson, a securities lending consultant and author, but that will change as the trend towards passive index investing continues to develop and ETFs win greater favour in the asset allocation process.

Andrew Jamieson, global head of broker-dealer and market-maker relationships at BlackRock, is seeing these very trends in action. He says: “It is almost a classic virtuous circle we are witnessing. As products become larger and more liquid, this pulls in more institutions, attracted by the liquidity. People are using the product [ETFs] more and more.”

Jamieson identifies a number of tailwinds driving ETF growth, especially when compared with other forms of structured products. “As regulations change, products such as over-the-counter (OTC) derivatives become ever more expensive. Because ETFs are larger, costs are lower and this benefit is passed on to investors.”

Growth in the adoption of ETFs will continue if fixed income investors increase their participation, says Jamieson, as the move towards passive index investing gains pace. ETFs provide a natural way to take a view on

What is the most important consideration to you when making a decision about what to post or accept as collateral?

- **Cost**
  - 27%
- **Liquidity**
  - 47%
- **Risk weighting**
  - 25%
fixed income and they offer greater liquidity than the usual alternatives. Fixed income investors in particular need to go long or short, and the ability to borrow ETFs is becoming essential.

These investors are in luck, because ETF liquidity is as robust as ever. According to recent data from the London Stock Exchange (LSE), there are currently more than 1,200 ETFs and ETPs listed on its main exchange, and the total value of ETFs traded on-exchange this year has reached £175.7 billion, notes Source ETFs, one of Europe’s leading ETP providers.

Most of the European investment in ETFs comes from institutional investors, but Source is forecasting that there will be a significant increase in demand from retail investors, primarily through their advisors. Over the past 12 months, nearly one in five financial advisors said their clients have increased their exposure to ETFs, as opposed to just 3 percent who have seen clients reduce it.

Over the next year, one in three independent financial advisors expect clients to increase their exposure to these investment products compared to 4 percent who anticipate exposure will fall. Some 59 percent of independent financial advisors said that lower charges give ETFs an advantage over other investment funds, followed by 21 percent who said it was about innovation, and 13 percent who cited the wide choice of ETFs available.

Source is already capitalising on this market growth. It has attracted $3.4 billion of assets so far this year (as of 15 September 2015), which is equivalent to 20 percent of the firm’s AUM at the beginning of 2015. Just over half of this, $1.8 billion, has been into fixed income ETFs, with $1.3 billion into equity ETFs and $300 million into commodity products.

Gillian Walmsley, head of fixed income and listed products at the LSE, said on 22 September: “London has long been seen as the capital of the ETF industry in Europe, with deep liquidity and a strong emphasis on promoting transparency. In 2015, 101 new ETFs and 25 new ETPs listed on the LSE. Total on-exchange value traded for ETFs this year is up 61 percent compared to the same period last year.”

Lee Kraneffuss, chairman of Source, added: “Our research shows that the UK and European market has huge potential for further growth. In a poll of more than 100 independent financial advisors in the UK, 14 percent of them said they do not fully understand ETFs, and 34 percent said that their clients do not fully understand them.”

The potential for retail investors is particularly intriguing. Jamieson says ETFs have the potential to democratise institutional investment practices, enabling retail investors to access the world of short and long performance.

Jamieson explains: “Retail investors couldn’t previously dream of being able to profit from an asset they have never owned. ETFs will allow them to do that. They [ETFs] are a unique phenomenon, a technology, a wrapper, rather than an asset class, which could become the biggest component of price discovery ever known in our industry. Securities lending is essential for the increased growth and greater operational efficiency in any market.”

ETFs appear to represent a ripe opportunity in European securities lending. Although barriers to their use do exist, efforts are being made to overcome them.

Mo M’Rabti, deputy global head international markets at Euroclear, says that post-trade processing, reducing costs and boosting liquidity are among the areas that need work before the uptake of ETFs as collateral in Europe can improve.

He says: “Borrowers have shown some appetite for borrowing ETFs, but the traditional model of issuing in different domestic markets with different codes and settlement procedures has meant the available pools of capital have been locked into silos, and fees have been high. Why pay 200 basis points for an ETF when you can borrow the underlying securities for 30 to 40 basis points?”

---

**Do you post or accept ETFs as collateral?**

<table>
<thead>
<tr>
<th></th>
<th>No</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>44%</td>
<td>56%</td>
</tr>
<tr>
<td>10%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>40%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>50%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>60%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
This helps to explain the discrepancy between the lending and borrowing of ETFs in the US single market and Europe’s fragmented markets—moving ETFs across borders is complex, costly, takes time and is not without operational risks. The centralisation of securities will help to redress the balance, says M’Rabti, as settlement in a single centre is evidently better than settlement in multiple places. “This is why issuers are pushing us to centralise post-trade processing in order to create a real single market for ETF securities in Europe. The market told us that post-trade plumbing was a real concern and we have addressed that.”

Euroclear is seeing a growing number of ETFs on its centralised international platform, which concentrates the settlement of ETFs in its international central securities depository (ICSD), paving the way for lenders and borrowers to interact more easily. BlackRock is issuing all new European ETFs via the platform and plans to migrate all of its existing ETFs over the next 12 to 18 months on a staged basis.

“Post-financial crisis, the ETF has been a success,” says M’Rabti. “Our pipeline of new issues is healthy and I am very optimistic. We have worked hard with the industry to get lenders contributing to a bigger centralised pool and to educate borrowers to the enhanced availability that our efforts have delivered. Having everything in one place will improve the prospects for securities lending involving ETFs. Lending boosts liquidity, which in turn boosts a market’s reputation.”

He adds: “ETFs, a booming asset class, have traditionally been prone to failed settlement; lending should help that and they could also be used as collateral and for securities financing, enabling the development of longer-term lending as is commonplace in the US. The potential is there and growth will accelerate within the ICSD model. Of that we are certain. We are seeing activity on our books and the model is working efficiently across multiple currencies and across all time zones.”

Richard Glen, head of global securities financing sales and broker-dealer relations in the UK and Ireland at Clearstream Banking, says: “In the changing world of collateral management, traditional counterparties have to make their balance sheets sweat more than ever. We have invested heavily in allowing clients to use a broad range of funds from mutual funds to ETFs as collateral.”

“As equities and ETFs are very much in vogue today, we spend a lot of time talking to clients to ascertain their requirements and with our links into multiple CSDs we can settle ETFs across our books in a similar way to equities.”

The European respondents to the Securities Lending Times and Markit survey who do not post or accept ETFs as collateral said they largely do so because there is not enough information available. Interestingly, one agent lender said there is a lack of demand for ETFs as collateral in securities lending, while a broker-dealer said they are usually not accepted, suggesting that beneficial owners are not confident in their knowledge or understanding of ETFs.

Mark Schaedel, managing director in the information division at Markit, which among other services assists ETF issuers with the mechanics involved in a new listing, stresses the need for cooperation and collaboration to improve knowledge and understanding. “We need to maximise the use of ETFs as a community. Everyone in that community has a common interest in seeing ETFs grow. ETFs, however, suffer from a lack of transparency, which is almost as big a hindrance to further development as the perceived lack of liquidity.”

Respondents to the Securities Lending Times and Markit survey offered a resounding view of what they believe to be the most inefficient aspect associated with posting or accepting ETFs as collateral. Some 60 percent said ETFs have too complex a risk profile and suffer from the lack of any standard identification process.

An increase in market transparency will need to be achieved to underscore the differences between individual ETFs. One of the most obvious is whether an ETF is physically backed by the purchase of the underlying paper or commodity, or whether it is synthetically backed.

### Why do you not post or accept ETFs as collateral?

<table>
<thead>
<tr>
<th>Reason</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of transparency</td>
<td>61%</td>
</tr>
<tr>
<td>Not enough information</td>
<td>29%</td>
</tr>
<tr>
<td>Operationally inefficient</td>
<td>11%</td>
</tr>
</tbody>
</table>
With physical backing, investors can touch the ring-fenced asset and not have third-party exposure.

Physical backing features in the approach that Markit has taken in doing to help drive the industry towards using ETFs as collateral by creating a number of standard ETF collateral lists. It draws inspiration from the paper authored by Roy Zimmerhansl and Andrew Howieson in 2012. This paper noted the lack of a comprehensive industry classification system and the inability to group ETPs based on certain criteria. Solving these problems would alleviate the need to deal with ETPs on an ISIN by ISIN basis. Pre-defined lists that follow risk department requirements would enable the grouping of ETPs onto a broader multi-asset collateral schedule.

Markit is well positioned to facilitate the classification and grouping of ETPs as it has been providing data services in the ETP and securities finance landscape for more than 10 years. "We want to highlight ETFs’ potential, using existing infrastructure,” says Schaedel. "We could see massive growth in the market once we work out how to use them better and introduce them to the retail investment mainstream.”

A sustained education programme will be required, teaching investors how to understand ETFs and how to use them, as well as about their qualities as an asset that can be lent and borrowed, he indicates. This would address, in particular, the perceived lack of liquidity referred to in almost any conversation on the topic. This, Schaedel attests, is illusory. “ETFs are of the same quality as the underlying assets. Why wouldn’t you accept a fund comprising shares if you would accept the shares themselves?”

The answer to that question is, he says, in the additional work needed to assess whether an asset class passes risk acceptability criteria, which is work done at fund level rather than at index level.

Schaedel explains: “If an asset is FTSE 100, it is acceptable, but not ETFs, where the risks are just not what they are perceived to be. With this in mind, we are trying to recreate workflow convenience for an ETF as we see for indices, to produce a list of ETFs that are very transparent for equities and fixed income.”

After a consultation period, Markit announced in August this year that it would publish two inaugural ETF collateral lists, for physical equity and physical fixed income. Markit’s ETF collateral lists would be based on key filtering criteria such as replication methodology of the ETF, country and index exposure, as well as tracking difference.

In the initial lists, an ETF will need to be physically replicated, which ensures that the collateral taker, when redeeming the ETF, will receive the underlying assets in the approximate weights of the underlying index and can benefit from the multiple disposal options. The filtering process provides assurance that the ETFs have met the approved criteria.

As market participants become comfortable with Markit’s standard ETF collateral lists, there will be opportunities to expand the filtering criteria to include other asset classes, indices, synthetic ETFs and more. This initiative should have positive effects on all aspects of utilising ETFs in Europe and will support their growth.

The ability for lenders and borrowers to agree on a group of ETFs as opposed to tackling the task on a case-by-case basis should bring much needed efficiency to the market, Markit notes in its whitepaper, The Case for ETPs as Collateral. "If we succeed in exposing ETFs to the securities lending market, it will be easier to trade ETFs and for hedge funds to take positions using them,” concludes Schaedel.

The rise of the ETF is as clear as the path towards their use as collateral in securities lending. ETFs are becoming more liquid as institutional and retail investors learn about their benefits. As that happens, they become more appealing to securities lenders and borrowers looking for transactions that strengthen the risk versus reward calculation in their favour. ETFs are here—and the work is well underway to ensure they stay that way.

What is the most inefficient aspect associated with posting or accepting ETFs as collateral?

- Complex risk profile: 38%
- Lack of available data: 23%
- Lack of standard identification process: 38%
Securities Lending Times and Markit conducted a survey of securities lending professionals to find out why ETFs are not widely used as collateral in Europe and what can be done to make them more acceptable to borrowers and lenders.

The survey was carried out online in August and September and attracted responses from across the industry, including investors, broker-dealers, lenders, triparty agents, heads of delta one sales, traders, hedge funds, central counterparties, capital markets managers and technology providers. The respondents predominantly hailed from Europe. The rest were located in North America, Latin America, the Asia Pacific and the Middle East.

The quantitative data was then supplemented qualitatively by a series of targeted conversations with senior industry players.

### Industry respondents by business

- **Agent lender:** 18%
- **Beneficial owner:** 2%
- **Broker-dealer:** 27%
- **Central counterparty:** 2%
- **Hedge fund:** 3%
- **Other:** 3%
- **Principal lender:** 18%
- **Technology vendor:** 5%
- **Triparty agent:** 8%

### Industry respondents by location

- **Asia Pacific:** 26%
- **Europe:** 65%
- **Latin America:** 2%
- **Middle East:** 2%
- **North America:** 2%
Optimise your securities lending programme.

Benchmark performance against a dataset covering $15tn+ of global securities in the lending programs of 20,000+ institutional funds. Enhance programme management with solutions for securities lending, repo, collateral management and trading analytics.

Learn more:
Sales@markit.com