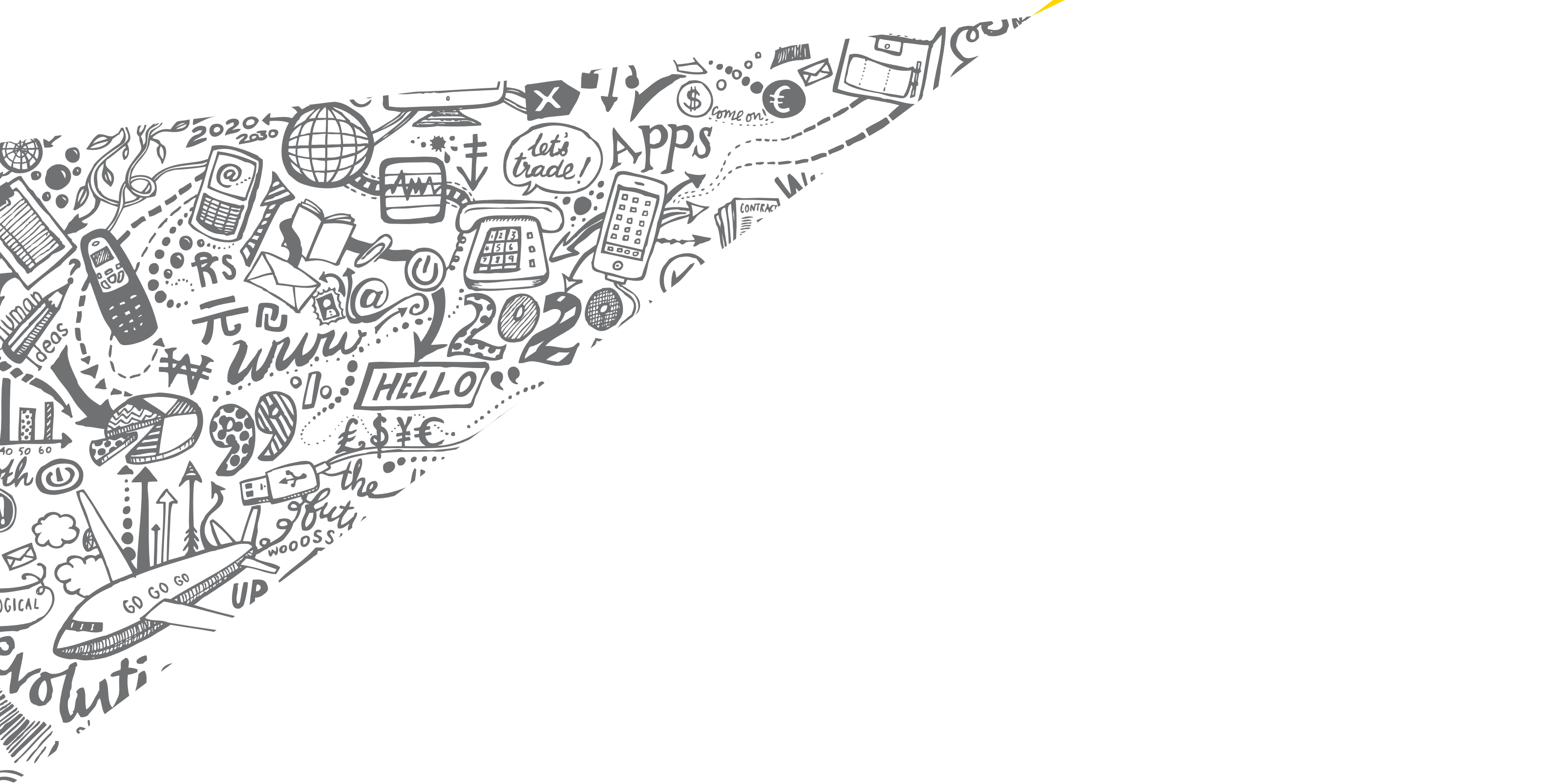
European ETFs: the game changer for growth in asset management

An Ernst & Young European Survey 2013



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ETF survey findings

The European market for exchange-traded funds (ETFs) has grown steadily in size and importance in recent years. The simplicity, liquidity and low costs of the industry's core index-tracking products have helped ETFs to weather the global financial crisis far better than many other investment products.

Despite this success, the value of European ETFs as a percentage of mutual fund assets is still less than half the comparable figure in the more mature US market. We expect ETFs to play an increasingly important role in Europe, in both the institutional and the retail spheres.

To better understand this important market, between July and September 2012 Ernst & Young conducted face-to-face interviews with more than 30 industry participants, including promoters representing more than 90% of the European ETF industry's total assets. We then presented the results to the industry at client road shows in Luxembourg, Paris, Dublin, London and Zurich, with panel discussions adding color to the survey findings.

Our experienced industry professionals analyzed the results, revealing a number of themes that cut across the industry. In this report we have grouped these under 12 key findings. The key findings examine the critical issues facing the European ETF industry, including retail demand, investor education, cost growth, barriers to entry, competition, consolidation, geographic expansion, innovation, regulation and tax. In the last section of the report, we set out the most important results of the survey in greater detail.

Overall, the survey revealed a rapidly maturing industry that, despite undoubted challenges, is noticeably more confident than many other areas of asset management. It is also coming of age at an ideal time, when investors are demanding cheaper and more transparent investment products.

Even so, in our last key finding we voice a note of caution. We believe that the European ETF industry needs to do more than invest in its own capabilities. It also needs to educate its key stakeholders, including investors, regulators and tax authorities. The better ETFs are understood, the more likely they are to fulfill their promise. A mature, successful ETF sector would not only benefit promoters and investors, but it could also play a crucial role in the rehabilitation of the European investment industry. That would benefit us all.

We hope you find this report interesting and, above all, useful. If you would like to discuss our findings in greater detail, we would be delighted to hear from you.

Lisa Kealy
Partner, EMEIA Asset Management ETF Leader

Key findings

1. European retail ETFs offer excellent prospects for medium- to long-term growth, but expansion is expected to be evolutionary, not revolutionary.

We expect European retail demand for ETFs to continue growing into the foreseeable future for a couple of reasons. First, the market for ETFs keeps growing at a time when other investment structures are struggling to retain funds. European ETFs recorded net inflows of US$7b during the first half of 2012, an annualized growth rate of 5.1%.[1] Second, the market is still maturing. Most interviewees see the European market as being 5 to 10 years behind the US market in terms of size, sophistication and product development. In Europe, ETF assets are worth 3.5% of the total for mutual funds. In the US, the equivalent figure is 8%.[2]

"Retail investors are important for growth in the short to medium term, and could become more so in the future."

Our survey interviewees agree with this analysis and expect retail ETFs to expand from their current level of 15% of the European total. Even so, few of those surveyed expect growth to be explosive; most predict moderate growth. Our own estimate is that retail ETFs will grow to represent 25% of all European ETF assets but that this is likely to take several years. Crucially, the attractions of ETFs could win back some of the trust that the investment industry has lost since 2008. Even so, Europe remains a fragmented market. It also lacks the self-directed investment culture of the US, with most retail investments sold through advisers or bank branches. Not every European country has the growth potential of markets such as the UK, Germany, France, Switzerland or the Netherlands.

2. Investor education is crucial to retail growth, and a big push by one or two major promoters should unlock stronger demand. The Retail Distribution Review (RDR) in the UK and comparable measures in other European Union Member States could also trigger retail demand for ETFs.

If European ETFs are to enjoy the level of growth that retail promoters are hoping for, distribution patterns will need to change. Comments from interviewees suggest that the industry is ready for major reconsideration of its current approach. The survey shows that banking networks are currently the most important channel for retail distribution, followed by independent advisers. Promoters with a private banking connection also find this to be a useful outlet for high net worth investors. In contrast, online accounts are much less important.

Our survey interviewees see investor education — getting investors to make their first ETF trade — as the most important driver of retail growth. The survey also shows that branding plays a vital role when investors choose between similar ETF products. There is a feeling in the industry that if ETFs are to gain traction among mass-affluent investors, one large provider will need to take the initiative and invest in a major promotional push. For promoters without access to a network of bank branches, focusing on investment platforms is likely to be the most effective way to engage with a large number of retail investors. There is potential for the first mover to establish a huge branding advantage, but market volatility may be encouraging promoters to bide their time.

"The RDR will help, but a cultural shift still needs to take place within Europe."

New regulations are also poised to give retail ETF sales a boost. The Retail Distribution Review in the UK and similar changes under Provisieverbod in the Netherlands will soon force financial advisers to charge upfront fees rather than rely on commissions. Retail distribution in both these markets will change significantly, albeit not overnight. ETF sales through financial advisers and private banks are expected to accelerate, with the strongest promoter brands reaping the greatest rewards. In the longer term, promoters hope to see European online ETF sales grow in the direction of current US levels. This will reinforce the importance of branding, but it will also require promoters to invest in their distribution platforms, which is an area already attracting regulatory scrutiny.

1 EFTGI Research
2 CISI/BlackRock/ICI/EFAMA

3. The cycle of cost growth, competition, falling margins and the need for greater scale will only continue — in fact, it looks set to accelerate.

Scale and momentum have always been vital to making sustainable profits from ETFs. For institutional investors in particular, scale is a measure of liquidity; most look for ETFs with more than US$100m in assets. For large-scale promoters – ideally with more than US$1b in assets – scale allows them to stay at the cutting edge of price competition and still achieve a sustainable profit. The importance of scale is increasing as the growing costs of regulation and registration drive up European providers' expenses. Larger players are also investing in more seamless cross-border distribution. Our survey shows that most promoters are planning to absorb their growing costs internally, reinforcing the vital importance of economies of scale.

"Some smaller firms may not get off the ground. They will struggle to raise assets in the face of competition from large providers."

Price competition is becoming ever more aggressive, particularly among ETFs covering major indices. In Europe around 10 ETFs cover the FTSE 100 index and almost 40 track the DJ Euro Stoxx 50.[3] As a result, most promoters expect continued pressure on management fees. Even so, there is no strong consensus on this issue. Many of those we surveyed expect a US-style pricing war to push down fees, but some expect fees to remain relatively unchanged, at least in the short to medium term.

Pressure on margins is not just expected to squeeze profits; it is also seen as a driver of consolidation. Most interviewees agree that the biggest players will get bigger, which in turn will lead to tighter margins and the need for even greater scale. And yet the survey also suggests that more promoters will enter the market over the next two years and that existing promoters will increase their range of ETFs. This will only add to the effects of competition. It is not surprising that survey interviewees predict a falling success rate of new launches, due either to excessive competition or to insufficient inflows.

There is one notable exception to the rule. Niche promoters that can successfully launch innovative ETFs do not have as strong a need for scale as promoters competing across a wide range of markets and indices. For those that can build a reputation as specialists, small can be beautiful. However, even these niche margins tend to be eroded by competitor imitation, so continuous innovation is essential to survival.

3 Financial Times

4. The need for scale is a major barrier to entry, and very few promoters will challenge the top three. Joint ventures are one solution, and there is also good scope for specialists to enter with a niche strategy.

The requirements of scale constitute a major barrier for new promoters entering the European ETF market. The fragmented nature of European listings — European ETFs are currently listed on at least 21 exchanges, compared with three in the US – adds further to the costs of entry. To seriously compete with or take market share from the leading promoters, new entrants need to offer products across a range of indices, markets and asset classes. This requires expertise, relationships with authorized participants, and access to institutional and retail distribution.

This means that the three largest European promoters are unlikely to lose their leading positions. Most of those surveyed expect the top three to maintain or increase their market share. Many feel that only a leading US promoter could now enter the European market with a feasible chance of becoming a major player. Several US promoters have looked at Europe, but most have been put off by the need for multiple listings. There are exceptions though: one leading US promoter launched five European ETFs during 2012. Other US promoters are watching with interest, but any followers will need to do their homework. The European ETF market is not only more fragmented than the US, but also completely different in terms of tax, distribution and investment attitudes.

Apart from a large US promoter, there are probably only a handful of second-tier players with the potential to turn the European top three into the top five or six. Even promoters backed by large banks may struggle to expand their current shares of European ETF assets. One way to get around the scale challenge is to use a partnership or joint venture. For US entrants, this could provide access to the distribution channels of a local promoter. For European players, it reduces cost and strategic flexibility. Examples include jointly owning a new promoter and opening up established platforms to fixed income or alternative investment specialists.

Another alternative is to enter with a niche strategy. Respondents see good scope for specialized promoters to develop innovative products. Ideally, a new entrant should have established niche expertise and enjoy the backing of a larger asset management group — or better still, a related bank. One such new entrant, the passive management subsidiary of a larger European asset manager, successfully launched four ETFs in 2011.

5. The industry is ripe for consolidation, with smaller players the most likely targets. Buyers could include rivals, US entrants or traditional asset managers. Consolidation among funds will also continue.

The majority of those surveyed expect the squeeze on margins and the importance of scale to drive consolidation within the European ETF industry. But what form will this take? The leading promoters, backed by large banks that have already invested to develop their scale, are unlikely to become takeover targets. Instead, many interviewees expect to see small promoters acquired by existing rivals or new entrants. Many deals will be stimulated by the need to sell, either due to a lack of scale or parent banks' need to raise capital.

The potential for consolidation is clear. At the end of June 2012, the US ETF industry was managing almost four times the money of its European counterpart, but with fewer ETFs (1,183 compared with 1,334 in Europe) and fewer promoters (34 compared with 39). At the same date, no fewer than 949 European ETFs held less than US$100m of assets, compared with 696 in the US.[4]

"Consolidation will occur. There are currently too many vanilla funds in the market."

Large European asset managers that have yet to develop an ETF business are likely potential buyers. They'll look either to grab a share of the ETF market or to defend themselves against erosion of their mutual fund assets. The chance to acquire expertise in a particular niche may prove especially attractive, and targets with established distribution links could appeal to US buyers.

Consolidation at the fund level is also likely to continue, as promoters opt to combine or delist funds that have failed to achieve sufficient scale. Even so, Europe will probably see fewer actual fund closures than the US market, due to the costs involved in closing funds with multiple listings.

6. European promoters are keen to expand in Asia, but there is no consensus on how to overcome the problem of fragmented regulation. The problems of cross-listing will remain a significant obstacle.

The survey shows that European ETF promoters see geographic expansion as their primary source of growth. Asia-Pacific is by far the most popular target region, but wanting to expand there is not the same as knowing how to do it. Promoters are far from certain about an appropriate approach or the structures most likely to succeed. Asia-Pacific is even more fragmented than Europe in terms of tax, distribution and culture, as illustrated by Asian ETF promoters' localized strategies. For US players eyeing the Asia-Pacific market, testing the water in Europe may therefore represent a logical step toward expanding in the Far East.

Uncertain or conflicting regulations are perceived to be the greatest barrier to a pan-Asian strategy. The difficulty of cross-listing between key Asian markets is a major problem, forcing entrants seeking a regional presence to add layers of cost. Hong Kong is often seen as the first step into Asia-Pacific, but few foreign products are licensed each year and cross-listing is problematic. So far no Irish ETFs have managed to list in Hong Kong. There is also concern that regulators in the region may have been put off by the European regulatory debate over synthetic ETFs.

"Regulators in Asia are a barrier to new entrants."

Some European promoters are pinning their hopes on Undertaking for Collective Investment in Transferable Securities (UCITS) ETFs, given the success of the UCITS brand in several key Asia-Pacific markets, but this does not avoid the cross-listing problem. Other promoters are considering duplicating local products in each target market. Those hoping that Asian fund passports will solve the problem are likely to wait a long time.

Asia-Pacific is not the only region to attract the attention of European promoters. In the longer term the expanding middle classes of Latin America could generate significant demand. Russia and the Middle East might also be sources of growth, subject to significant changes in regulation, infrastructure and investor attitudes. In the meantime, mature markets where ETFs are underdeveloped are appealing. Japan is the largest such market, but Australia also offers scope for growth. Self-managed accounts represent about a third of Australian superannuation funds, and some platforms now allow customers to invest directly in ETFs.

7. Innovation is a vital source of differentiation and a compelling route for market entry. Successful innovators stand to gain first-mover advantage, higher fees and greater customer loyalty.

Competitive pricing is vital for ETFs covering the major indices, where products are sold rather than bought. Even so, this is little more than the price of entry. A strong reputation for liquidity, based on scale and momentum, is an essential source of promoter differentiation. Move away from index-tracking ETFs, and the picture changes. As products become more specialized, differentiation shifts away from scale and toward innovation.

Innovation in the ETF industry is largely driven by reverse enquiry from investors. Survey interviewees view new entrants as the strongest source of innovation and see new products and strategies as the second most important source of growth after geographic expansion. Promoters that can build a reputation for innovation stand to gain significant advantages in growth and scale. This implies a clear first-mover advantage, a conclusion reinforced by the limited capacity for specialized ETFs in the current European market.

> "More innovation is essential for new entrants. There are loads of vanilla products on the market already."

Promoters that can differentiate themselves in a particular corner of the ETF markets also have the scope to earn higher fees, although these tend to become eroded over time. They may enjoy greater customer loyalty too because innovative ETFs are most likely to attract institutions like pension funds with a particular need for defined outcomes.

Nonetheless, innovation in the European ETF market is not limited to niche providers. Even large, mainstream promoters are using innovation to round out their portfolio, offer a full spread of investment strategies and defend their market shares against more specialized competitors.

8. Innovation in European ETFs is becoming increasingly complex, often driven by specialized entrants from the US. However, regulatory changes are likely to limit the industry's innovative zeal.

One area of product innovation is enhanced beta or smart beta ETFs that blur the line between passive and active management approaches. Some of the most common types are low-volatility ETFs, leveraged ETFs and inverse ETFs. Some interviewees would like to see closer regulation of leveraged ETFs, but they are increasingly popular among institutional investors. Another area of innovation is customized index ETFs. These may be developed in-house or by a related investment bank and often focus on a particular industry or sector within the equity markets. Proprietary indices are also being developed for dividend-weighted or fundamentally weighted ETFs.

> "Yes, US players will try to enter the European market. There are many specialized players in the US."

Structural changes offer a different approach. These can often be driven by tax considerations, with exchange-traded notes the most obvious example. These instruments can offer tax advantages and are understood to lie outside the current scope of the European Securities and Markets Authority (ESMA) or UCITS regulations, but they could run the risk of leaving investors exposed to an issuing bank. As a result, there is the possibility that any liquidity problems affecting an issuer could cause reputational damage to exchange-traded notes (and perhaps to ETFs by extension).

One overall feature of innovation in ETF markets is that new products become cheaper and more available over time, making them accessible to smaller institutions and even retail customers. Another feature of the European market is that promoters tend to look to the more mature US market as a source of ideas and innovative new entrants. Concern about regulation is another aspect of the market. There is a sense that regulatory changes are likely to have a dampening effect on the European industry's ability to innovate.

9. ESMA proposals for pan-European ETF regulation are dominating debate within the industry. The latest version addresses some concerns, but the ultimate impact of the new rules remains uncertain.

Even though European ETFs have until recently been largely used by institutional investors, they have long been regulated like retail products under conduct measures that are becoming progressively more stringent. They are also subject to listing requirements. A strong majority of survey interviewees feel that ETFs have been unfairly caught unprepared by regulation aimed elsewhere. The risks of cross-regulation remain, but the industry now also faces the prospect of new, targeted regulations. The mood of the regulators is also becoming more prescriptive and interventionist.

ESMA has recently published its amended proposals for ETF regulation. On the upside, the latest draft has addressed some of the industry's earlier concerns by broadening its scope to cover all index-tracking UCITS. It has also pulled back from classifying synthetic ETFs as complex products. These changes reduce the risk of putting ETFs at a disadvantage to other UCITS and have removed some of the uncertainty over the future of synthetic ETFs.

Set against that, the ESMA proposals still contain areas of uncertainty. Despite the changes that have been made, improvements to current taxonomies will be required if questions over the treatment of synthetic funds are to be entirely dispelled. It also remains unclear whether exchange-traded notes will be covered by the proposed regulations, as indicated above.

Above all, the current draft sets out several changes causing concern in particular areas of the industry. One such change is that promoters will be required to return their net profits from securities lending to funds. This measure will be controversial, impacting all UCITS but also hitting certain physical ETF specialists particularly hard. It may give synthetic ETF specialists a boost. A second proposal that ETFs must be diversified to remain under the UCITS umbrella has particular significance for commodity ETFs, which usually focus on a single asset type. Our survey shows that promoters' responses are likely to divide between restructuring funds to hold four or five commodities and moving to a new regulatory structure, such as an Irish Qualifying Investor Fund (QIF).

"The ESMA ETF guidelines were not as bad as first feared, but the securities lending guidelines will have a significant impact on providers who currently retain this income."

Other proposals from ESMA include a requirement for actively managed ETFs to disclose how their strategy indices are calculated and restrictions on the ability of enhanced beta ETFs to use leverage. It is no surprise that ESMA's plans have jumped straight to the top of the European ETF industry's regulatory agenda.

10. European ETFs will be affected by a range of other regulations, with varying effects. Some could prove contradictory. What they have in common is a tendency to push up costs.

The proposed ESMA rules may have grabbed the attention of European promoters, but they are not the only regulations reshaping the ETF market. A range of further initiatives are in the pipeline, each with the potential to shape the development of the market — particularly in the retail arena.

Some regulatory changes are expected to be more beneficial than others. Among the most immediate are the fast-approaching changes to retail distribution in the UK and the Netherlands. As already mentioned, these are widely expected to give a boost to retail sales by putting ETFs on a more even playing field with other investment products. MiFID II may also help by improving market liquidity — a key selling point for ETFs.

Other changes may not be so helpful. Although still some way off, there are concerns that UCITS VI will roll back some of the changes to asset eligibility made by UCITS III, limiting the development of new ETF strategies. The proposed European Market Infrastructure Regulation (EMIR) is also expected to limit the use of derivatives by increasing the required collateral, pushing up costs. And the European Commission's proposals on Shadow Banking Reform are darkening the outlook for ETFs by treating them similarly to money market funds and adopting prescriptive approaches to stock lending and securitization.

It is also notable that European regulatory changes do not always work in harmony. The goals of EMIR and UCITS VI seem to contradict ESMA's approach, which focuses on the systemic risks of physical securities lending. ESMA's proposals for fuller disclosure of liquidity risks and stressed market scenarios also run beyond the aim of UCITS IV; the Key Investor Information Document (KIID) is arguably inadequate to capture the risks of many ETF products. Unless taxonomies are developed and reinforced, inconsistencies will remain a feature of the European market for the foreseeable future.

What all these proposals do have in common is a tendency to push up costs. Drivers include the loss of securities lending income, along with the need for more onerous regulatory reporting, more detailed disclosure, more capable IT systems and more complex processes. As already mentioned, many promoters do not plan to pass on these costs. This implies that regulation will accelerate the search for scale, increase barriers to entry and encourage the biggest players in the industry to get even bigger.

11. As the ETF industry matures, tax is becoming an increasingly complex issue, both in terms of reporting and at an investment portfolio level.

Regulation may be a leading concern of many European ETF promoters, but it is not their only source of uncertainty. The survey suggests that most European tax authorities currently take a neutral view of ETFs, but this may reflect unfamiliarity over their status as listed investment vehicles. Attitudes could still harden, especially as retail ETF sales increase. To prevent this, the industry should educate not only investors but also tax authorities about the structure, performance and risks of ETFs. Promoters also need to ensure they are doing all they can to understand the underlying tax position of their investors.

"Certain jurisdictions require evidence of ultimate beneficial ownership. This is not currently possible."

Turning to specifics, the growing cross-border distribution of ETFs is creating investor reporting issues not often faced by mutual fund managers. Differences in national tax reporting requirements are a real challenge for European promoters and administrators. Determining the ultimate beneficial owners of funds, a requirement in some jurisdictions, is a particular problem. This is an area with significant reputational risk, where mistakes often lead to promoters being called before fund boards and tax authorities. Promoters need to engage actively with service providers to ensure they are doing all they can to mitigate these risks.

At fund portfolio level, the tax challenges for ETFs are much more similar to those facing their mutual fund counterparts. The growing popularity of emerging market assets and the increasing use of derivatives are making investment tax management a critical issue. Minimizing these operational taxes is a particularly valuable opportunity for ETF managers, given their extremely thin margins. Promoters should avoid giving all operational tax responsibility to their administrators. Again, closer engagement is more likely to pay dividends. As European ETFs grow, the industry needs to stay alert and avoid getting tripped up by tax.

12. The European ETF industry is increasingly confident and mature. Educating investors and other stakeholders will be crucial to future success, enabling the industry to fulfill its promise.

Our survey and subsequent client road shows have given us invaluable insight into the European ETF market. They have also left us with some fascinating impressions of an industry that scarcely existed 10 years ago but that continues to gather assets steadily and enjoys more positive prospects than many other areas of asset management.

This is an industry that is maturing quickly. Although it is often described as if it were a single product, the European ETF market is becoming more complex and diverse. Some promoters are focusing on the retail market, while others are avoiding it. Some are working alone, while others are seeking partnerships. Some are competing on cost alone, while others focus on innovation.

"The greatest challenge for the industry is to try to keep costs low while implementing more regulation."

Most strikingly, and despite undoubted challenges, the European ETF industry is noticeably confident. It is coming of age at a highly opportune moment, as the wider asset management sector faces growing investor skepticism and pressure to reduce fees. The belief of ETF providers that they are creating value for investors, and the fact that investors share this view, is in stark contrast to many other areas of European asset management.

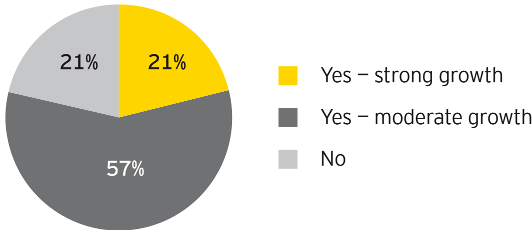
Even so, we deliver a note of warning. As ETFs grow in importance, they are attracting growing attention from a range of stakeholders. To maintain confidence and secure its future, the industry not only needs to invest in innovation, distribution, compliance and reporting, but it also needs to educate investors, regulators and tax authorities, many of whom still have a poor understanding of ETFs. The better ETFs are understood, the more likely they are to enjoy continuing growth and avoid the danger of reputational damage or a backlash from the authorities.

If this can be achieved, then the European ETF industry will justify its current optimism and be able to fulfill its full potential. A successful ETF sector could play a crucial role in regaining the trust of European investors. That would not only benefit promoters and investors, but also governments and society at large.

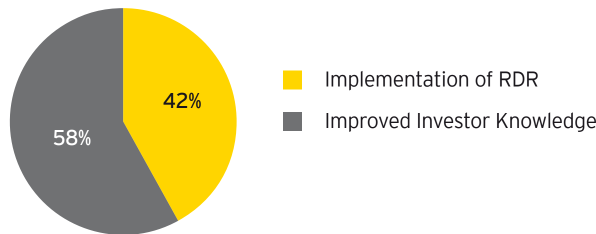
Survey results

Retail ETF growth

Are retail investors key to future growth?



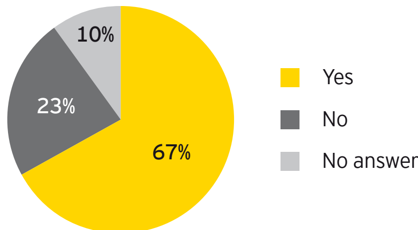
What will drive retail growth in the future?



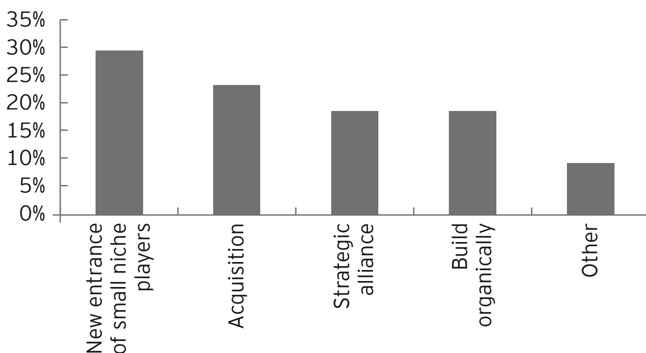
- Some of those surveyed expect European retail ETF sales to accelerate as the market catches up with US levels of demand. Others are less optimistic, citing Europe's more cautious retail investment culture and greater regulatory complexity.
- Overall, the majority expect retail ETF sales to continue growing at a moderate rate. A handful of markets including the UK, Germany, France, Switzerland and the Netherlands are expected to account for most retail growth.
- Knowledge of ETFs – getting investors to make their first trade – is seen as critical to future growth. Many of those surveyed are waiting to see which provider will make the first big promotional push. Promoters plan to work with platforms to educate and stimulate retail investors.
- Regulatory reform, especially in the UK and the Netherlands, is also seen as an important enabler of retail growth.

New entrants and barriers to entry

Will more promoters enter the market over the next two years?

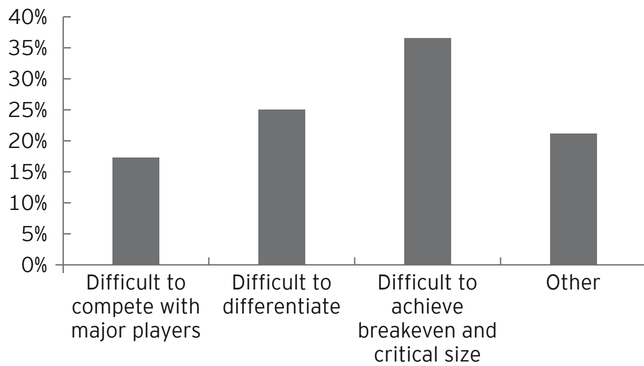


If so, how will they enter?



- A strong majority of those surveyed expect to see new entrants to the European ETF market over the next two years. The range of entry routes reflects the growing importance of the market to a variety of players. Some, such as mutual fund providers, may enter the market as a defensive move.
- Niche players with specialized strategies are expected to be the most common entrants. This could include specialized active managers launching ETFs and niche US players moving into Europe.
- Acquisitions, which again might include US firms entering the European market, are seen as another major avenue.
- Alliances offer a way to quickly build scale and gain access to platforms or distribution, but they reduce strategic flexibility. The costs of organic growth mean that this route is most likely to appeal to established asset managers.

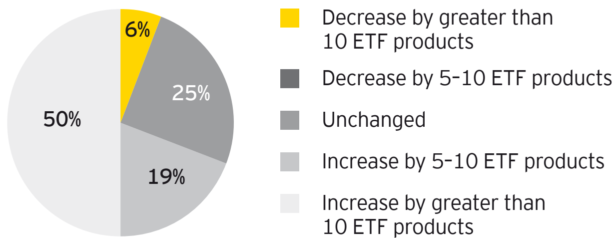
What are the barriers to entry?



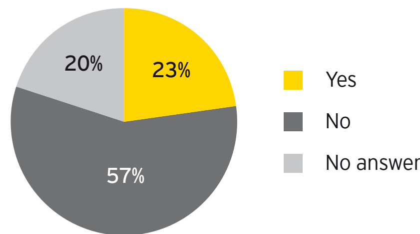
- Scale is clearly identified as the major barrier to entry. It is intrinsically hard to achieve in a market where a handful of promoters already control the majority of ETF assets.
- The required investment in listings, registrations and branding means that most new entrants struggle to break even. Europe's fragmented market is particularly expensive, reflecting cross-listings and variations in tax, regulation and distribution.
- New entrants focusing on major indices find it hard to differentiate themselves from established rivals offering better liquidity and stronger reputations.
- As discussed below, innovation offers the best way for new entrants to overcome these barriers, but it does not remove them entirely.

New launches and performance

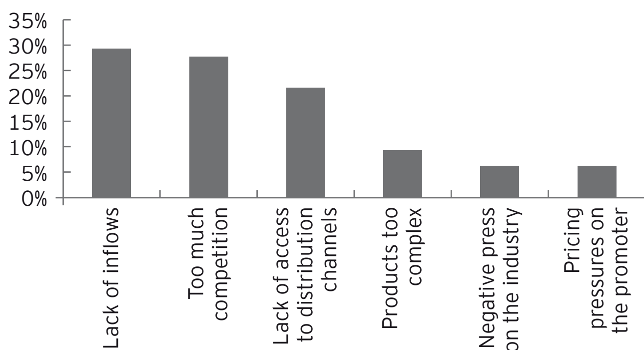
Do you plan to increase or decrease the number of products you offer over the next two years?



Will the success ratio of new launches improve in the future?



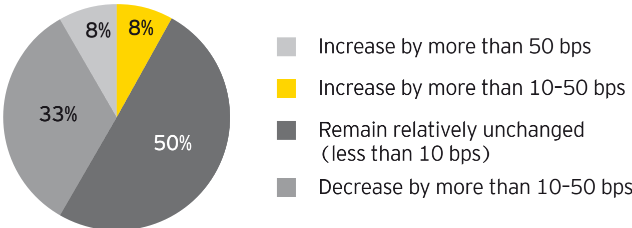
Which factors will have a negative impact on the success ratio of new launches?



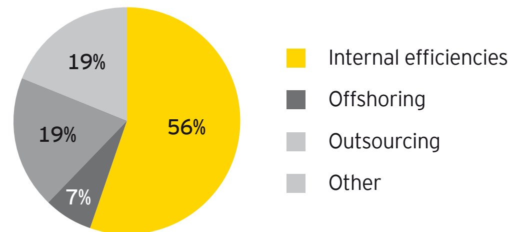
- Respondents' views on new launches could be interpreted as contradictory. The majority of those surveyed plan to launch new funds over the next two years, but many also expect the success of new launches to decline.
- Despite this, the fact that promoters continue to launch new funds is not illogical. One fund that succeeds in gaining critical mass has the potential to make up for a number of failed launches.
- The most common reasons for the failure of fund launches come as no surprise. The primary problem, insufficient inflows, is a reflection of other factors, most notably excessive competition and a lack of distribution reach.
- At an industry level, this implies that fewer funds should be launched. In practice, the drive for scale encourages promoters to continue to expand their range of funds in search of market share.

Competition and consolidation

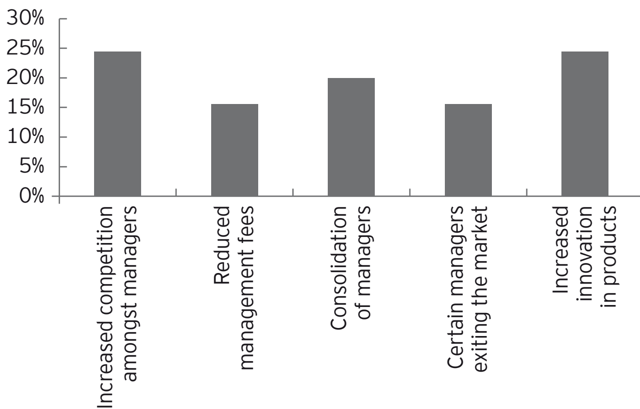
Will margins (management fees) for promoters tighten in the future? (Promoter responses only)



How do you manage the cost pressure?

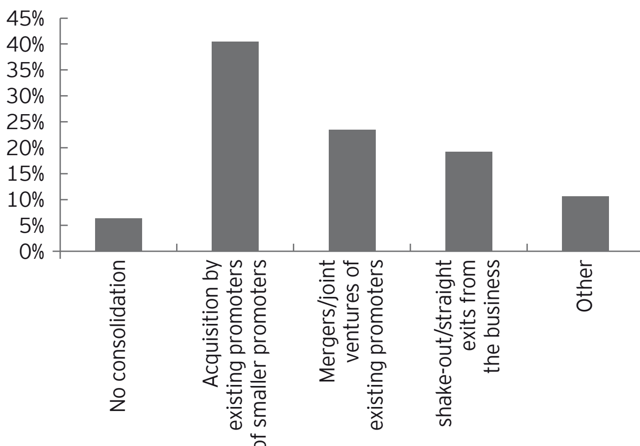


What effect will new entrants have on the industry?



- The major effect of new entrants to the European ETF market is expected to be to reinforce some of its key features.
- Competition is predicted to increase and fees are expected to come under greater pressure. As a result some players will withdraw from the market and others will be absorbed via consolidation.
- The other crucial effect of new entrants will be to stimulate product innovation, keeping the ETF industry at the cutting edge of asset management. As already mentioned, respondents see innovation as important for promoters seeking to overcome barriers to entry.
- It is no surprise that views on fees are slanted toward the downside. Even so, while 42% of promoters anticipate further price competition, 50% expect fees to remain stable.
- It is striking that most firms expect to absorb costs pressure through internal efficiencies, further reinforcing the importance of scale. A surprisingly small number expect to use outsourcing or offshoring to manage costs pressure.

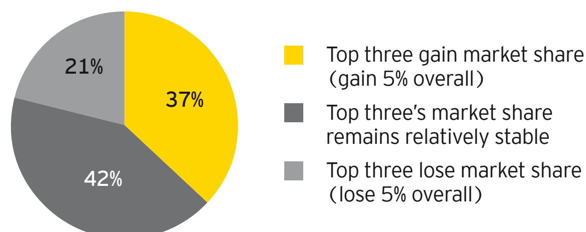
What is the likely method of consolidation among promoters in the market?



- Most players expect fee and cost pressures to drive consolidation in the European ETF market. Total European ETF assets are a quarter of those in the US, but the European industry has more promoters and funds.
- Larger promoters from Europe and the US are expected to acquire smaller European rivals. Smaller players are also expected to combine or enter into partnerships in search of scale.
- Those surveyed also expect to see further consolidation at the fund level, as promoters withdraw or delist funds that have failed to attract sufficient levels of total assets.

Market structure

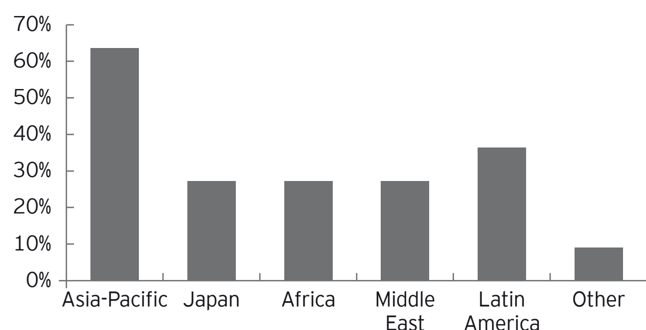
How will the domination of the largest players evolve?



- Despite the efforts of new entrants, margin pressure and consolidation are expected to support the status quo in the European market.
- Most respondents expect the top three players to defend or expand their current market share of around two-thirds of European ETF assets. Even so, 21% of those surveyed expect the top three to be challenged – probably by a large entrant from the US.

International expansion

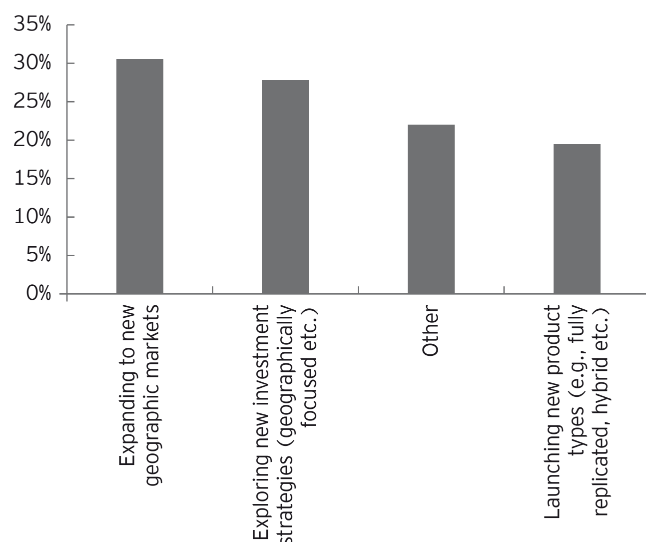
What expansion to your distribution network are you currently considering? (Promoter responses only, multiple responses permitted)



- Asia-Pacific is the most popular region for future expansion. Some firms hope the UCITS brand will help to spur demand, but cross-border distribution in the region remains difficult. China is the ultimate prize, but developed markets such as Korea are more promising in the short to medium term.
- Japan, a much more mature market but one where ETFs remain comparatively sub-scale, is also seen as attractive.
- Other emerging regions are seen as offering good long-term potential for expansion, subject to developments in regulation, infrastructure and investor demand.
- Some of those surveyed believe the fragmented European market could be a useful starting point for US promoters looking to target Asia-Pacific in future.

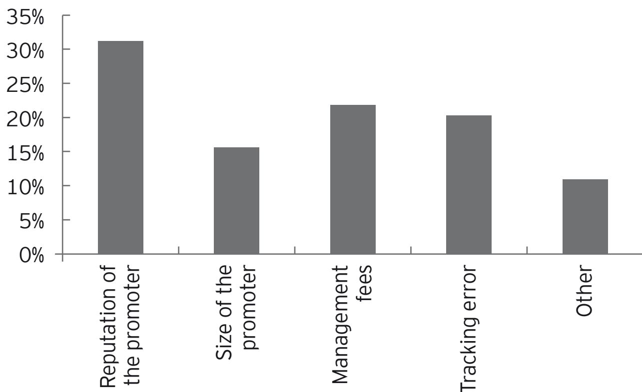
Innovation and differentiation

Which strategies are you targeting for growth?



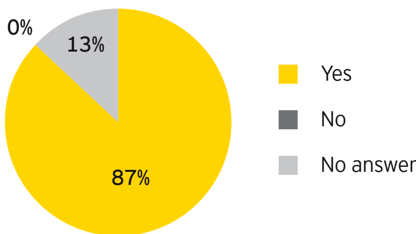
- Apart from geographic expansion, innovation in its various forms dominates plans for growth.
- New investment strategies are the most popular area of innovation, with many promoters continually developing new ideas in search of a competitive edge. This is also the quickest way to bring a new, innovative product to market.
- New types of funds, typically enhanced beta and actively managed ETFs, are the second most common area of focus. Some respondents also expect to see new fund structures emerge in response to regulatory changes.
- Although innovation is particularly important for niche players, large promoters are also launching innovative funds to round out their product ranges and defend market shares against specialist rivals.
- Excessive or inconsistent regulation, discussed below, is seen as a likely threat to innovation by some.

Where promoters offer competing products, what are the most important criteria for investors selecting a promoter?



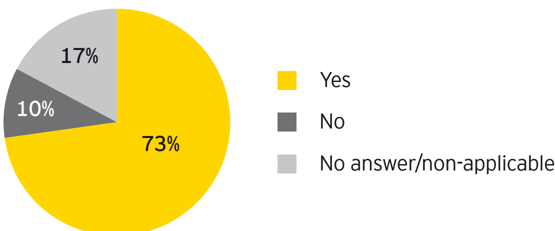
- Those surveyed believe reputation plays a critical role when investors face a choice between similar products. This is seen as a more important criterion than financial factors such as management fees or tracking error.
- When choosing between mainstream index products, institutional investors place the highest value on a reputation for good liquidity. Management fees, tracking error and other costs are also seen as important. Retail investors tend to put the greatest focus on fees.
- Away from these mainstream funds, a reputation for innovation can be more valuable. This is reinforced by the overwhelming importance of first-mover advantage. Promoters that develop a reputation for innovation often benefit from greater customer loyalty.

Is first-mover advantage as important as the European industry grows?

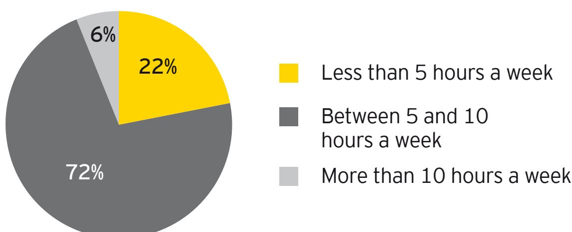


Regulation

Have ETFs been unfairly caught in cross-regulation?

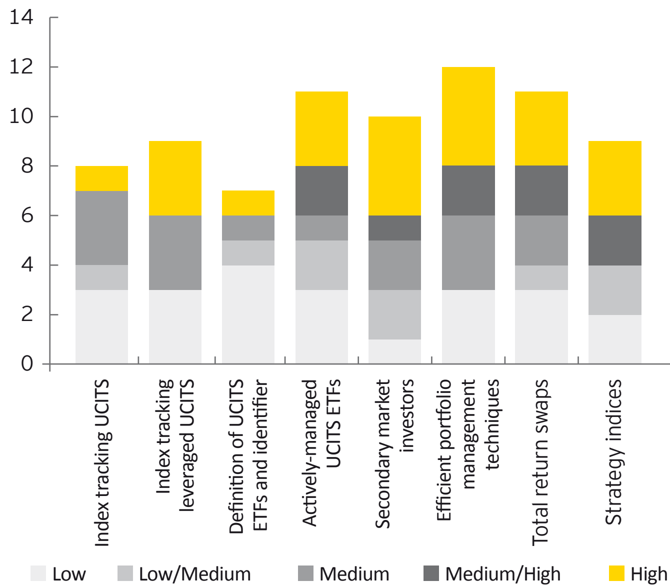


How much time do you spend dealing with new regulation and regulatory responsibilities?



- Most respondents feel that European ETFs have been unfairly caught in cross-regulation. Largely institutional products until recently, ETFs have long been regulated as retail funds. As listed vehicles, they also face tighter regulation than mutual funds.
- Some regulatory initiatives are expected to have a positive effect on European ETFs. The most notable is the end of hidden commissions in the UK and Netherlands retail markets, but MiFID II will also help by boosting liquidity.
- Other regulations are a source of concern. Restrictions on asset eligibility under UCITS VI and on the use of derivatives under EMIR could limit the industry's scope for innovation.
- Many of those surveyed spend 5 to 10 hours a week dealing with new regulation. This underlines the commercial cost of compliance. Some also highlighted the inconsistencies in European regulation, such as ESMA's push for greater disclosure, in contrast to UCITS IV's introduction of the Key Investor Information Document.

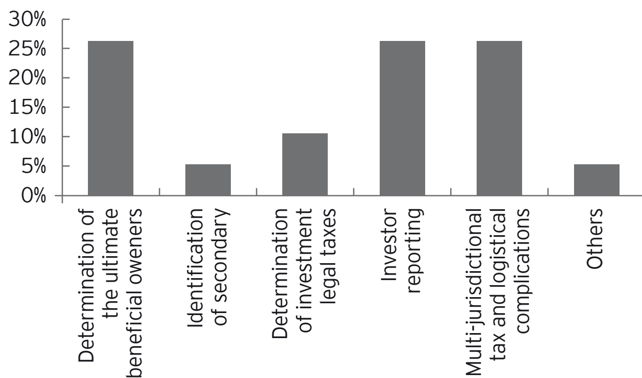
Rank the impact of ESMA implementation on these ETF products and areas of the industry. (number of responses)



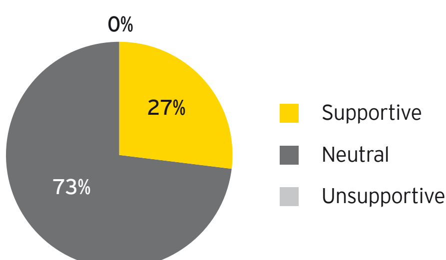
- ESMA's specific proposals for ETF regulation have jumped to the top of the industry's agenda.
- Although the latest draft has addressed some industry concerns, it remains vague in several key areas, including the treatment of synthetic ETFs.
- The proposed requirement to return the net profits of securities lending (or efficient portfolio management) to funds would represent a major cost for physical ETF specialists.
- The proposal for actively managed ETFs to disclose the calculation of their strategy indices is also a concern.
- ESMA is proposing to set limitations on the use of leverage by enhanced beta ETFs. This would be welcomed by some in the industry but is a concern for others.

Tax

What are the leading tax issues for the ETFs you manage or support?



Do tax authorities have a broadly supportive, neutral or unsupportive understanding of ETFs?



- Some of the leading tax challenges for European ETFs stem from the widespread cross-border distribution of funds. This problem is only growing as promoters seek greater scale and smoother cross-border distribution.
- Ensuring that funds meet the tax reporting needs of each investor is extremely complex. Requirements vary from the straightforward to detailed daily reporting. This is an area where mistakes carry significant potential reputational risk for promoters and administrators.
- More fundamentally, identifying the ultimate beneficial owners of funds is a particular challenge and can, for example, impact a fund's ability to access double tax treaties. Managing the changing and increasingly complex area of investment-level taxes is a broader issue for promoters and their service providers. In the ETF space this is exacerbated by the same creation and redemption process between funds and market participants.
- There are broader concerns about how well investors and European tax authorities understand the hybrid nature of ETFs – typically being both shares and collective investment vehicles – and the tax implications that follow. Some tax authorities treat physical and synthetic ETFs differently, and in some markets there isn't a level playing field between domiciles when it comes to funds' double tax treaty access. Although respondents' views on tax authorities are balanced slightly to the positive, there is a sense that authorities could yet be swayed from their neutral position to a less supportive stance.

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