

WHITE PAPER

A NEW ETF ASSET SERVICING PARADIGM EMERGES



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Now more than 30 years old, Exchange Traded Funds (ETFs) have enjoyed astronomical growth since their inception, while the products themselves are becoming increasingly diverse and complex.

These changes are forcing ETF asset servicers to adapt, but many are struggling to do so.

Although many providers are investing heavily in their businesses, most of this capital expenditure is either being earmarked for maintaining legacy technology or for supporting highly bespoke builds for specific clients.

This is making it harder for asset servicers to both innovate and standardise their technology, which in turn is preventing them from achieving scalability.

In this paper, Calastone looks at how asset servicers can overcome these challenges, enabling them to meet the requirements of the rapidly transforming ETF industry.

ETFs IN 2024 – BIGGER, MORE DIVERSE, AND HIGHLY ESOTERIC

With assets under management (AuM) in excess of \$11 trillion and nearly 12,000 products globally, ETFs are one of the most popular investment products in the market today, and their seismic growth shows no sign of decelerating (Fig 1).¹

Global ETF and ETP Growth

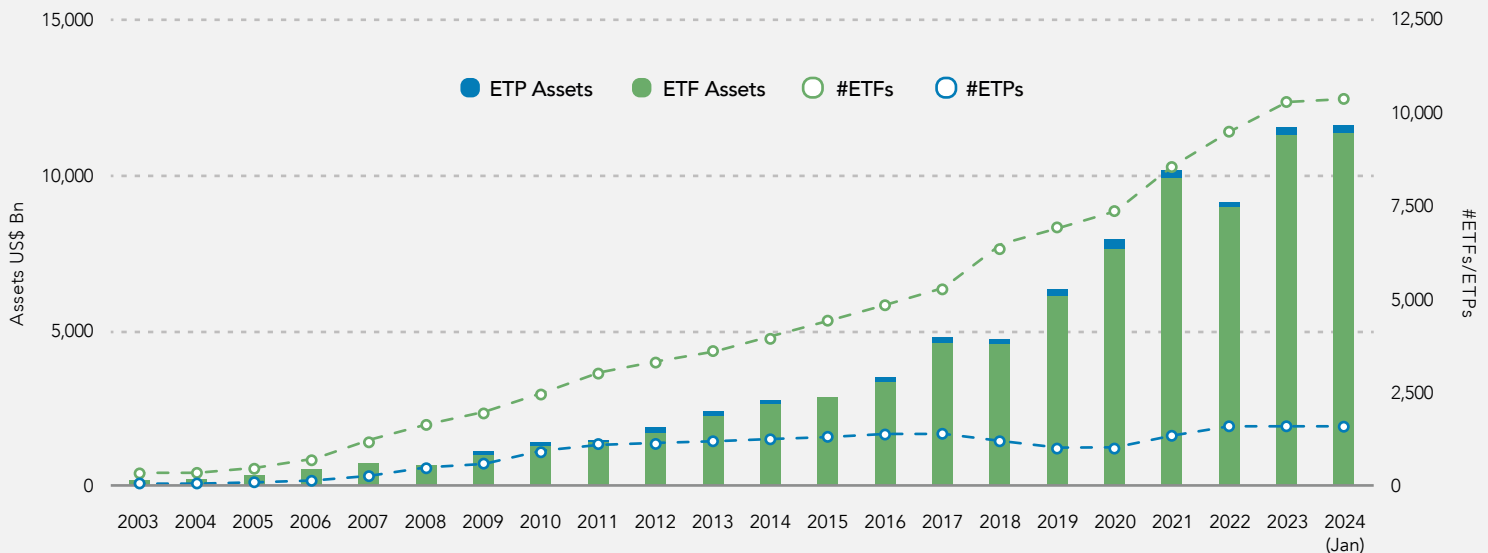


Figure 1

According to a survey of ETF market participants by PwC, seven in ten respondents anticipate ETFs will be running at least \$15 trillion globally by 2027, while a further 29% expect the industry could accumulate more than \$18 trillion.²

The ETF market is getting progressively bigger, more sophisticated, and increasingly esoteric in terms of its underlying holdings, and this is forcing asset servicers to evolve - and fast.

Once dominated by just a handful of large issuers, ETF providers (and funds) have become more ubiquitous, as a growing number of new entrants come to market (Fig 2).³

In addition to becoming an increasingly sizeable asset class by AuM, ETFs are also getting more complex by design

Historically, ETFs were fairly vanilla constructs, offering investors exposure to major indices.

However, there is now a growing supply of actively managed and semi-transparent ETFs, mutual fund ETF conversions, together with thematic, inverse, derivative-based and even leveraged ETFs. Earlier this year, the US Securities and Exchange Commission signed off on a spot Bitcoin ETF, a decision that could potentially spark a flurry of crypto-currency focused ETF launches.

¹ ETFGI.com – February 2024

² PwC – ETFs 2027: A world of new possibilities

³ ETF Stream – January 10, 2024 – Five ETF trends to watch in 2024



Figure 2

ETF ASSET SERVICERS FEEL THE PRESSURE

ETF asset servicers, despite their best efforts, are finding it challenging to adapt to these changes.

While many of the older asset servicers are investing in their organisations, the reality is that a lot of this spend is being allocated towards maintaining legacy technology stacks, as opposed to developing innovative solutions.

New ETF asset servicing entrants may have better technology than some of their more established peers, but they are challenged to further invest in it, given the slower growth of their Assets under Administration (AuA) base.

The inefficiencies this causes is adding extra basis points on for investors when buying and selling ETFs.

The lack of progress around automation, particularly around facilitating the subscription and redemption process, has been flagged by clients of asset servicers as being a problem in recent Calastone research.

This is a major issue for the industry.

Underpinning primary market liquidity is the ETF creation and redemption process, the importance of which was highlighted in Calastone research (Fig 3). The ability to create or redeem ETFs efficiently and at a known cost is a critical prerequisite for market makers, upon whom ETF issuers and investors are so reliant.

How do you measure the success of ETF fund administration services you receive? (select all that apply)

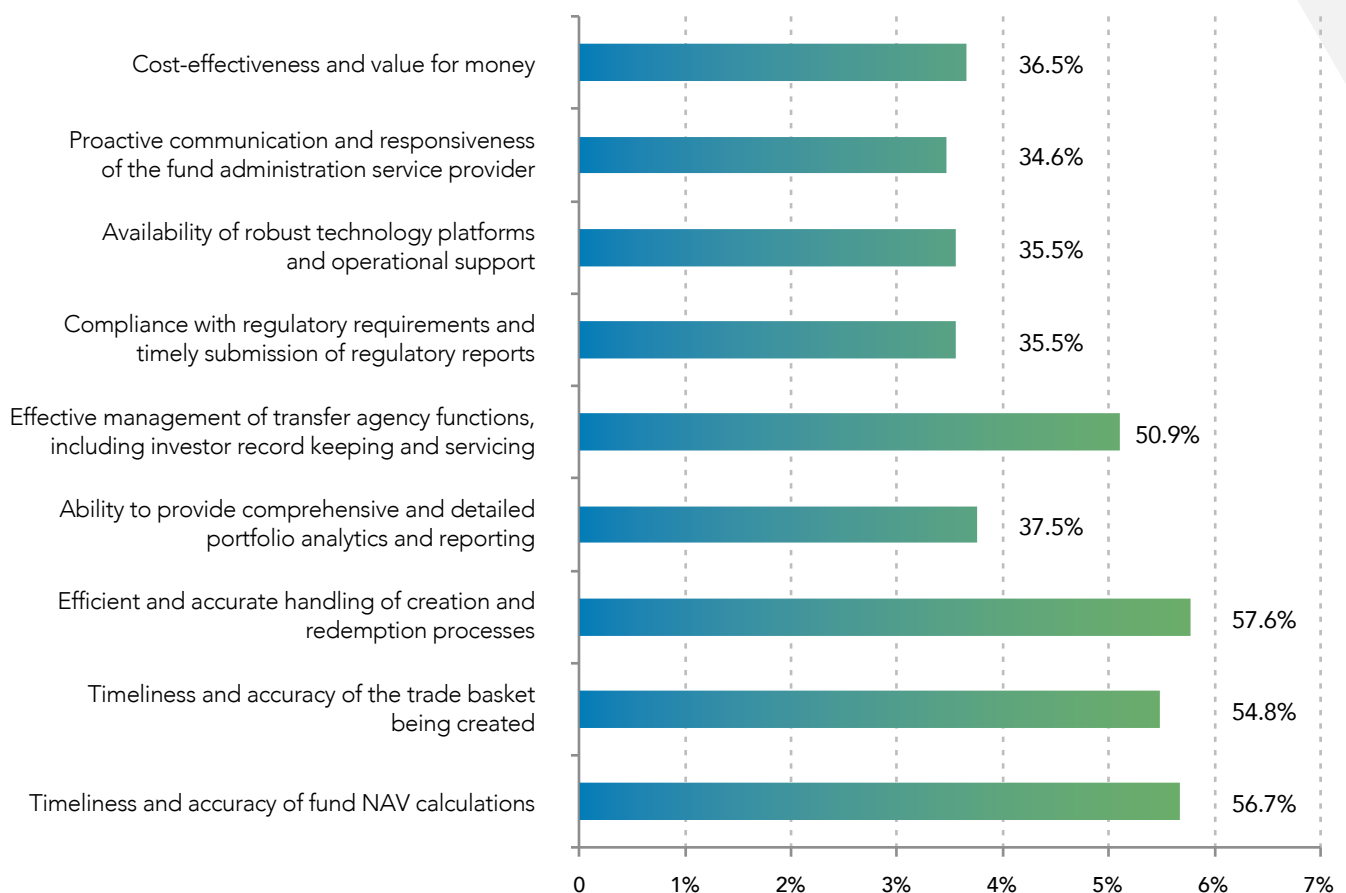


Figure 3

41.4% of issuers surveyed by Calastone said that the creation and redemption process was one of the two areas of ETF servicing most in need of improvement (Fig 4), yet their demands are clearly not taking precedence at asset servicers.

What are the two areas of ETF servicing that you would like to see improvements in? (pick two)

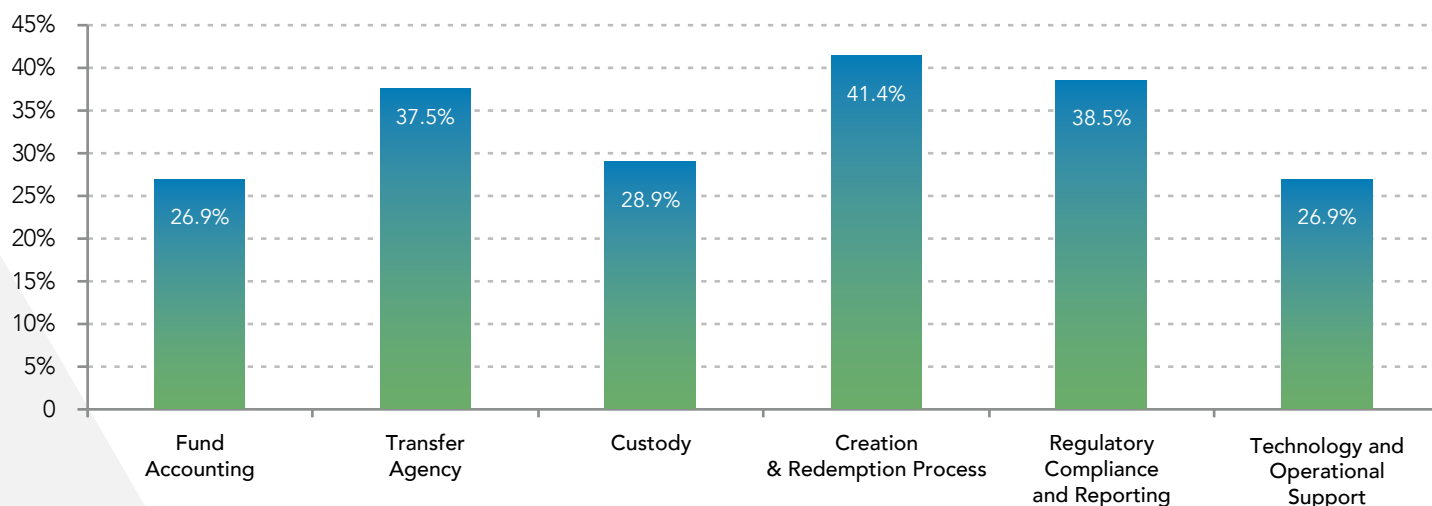
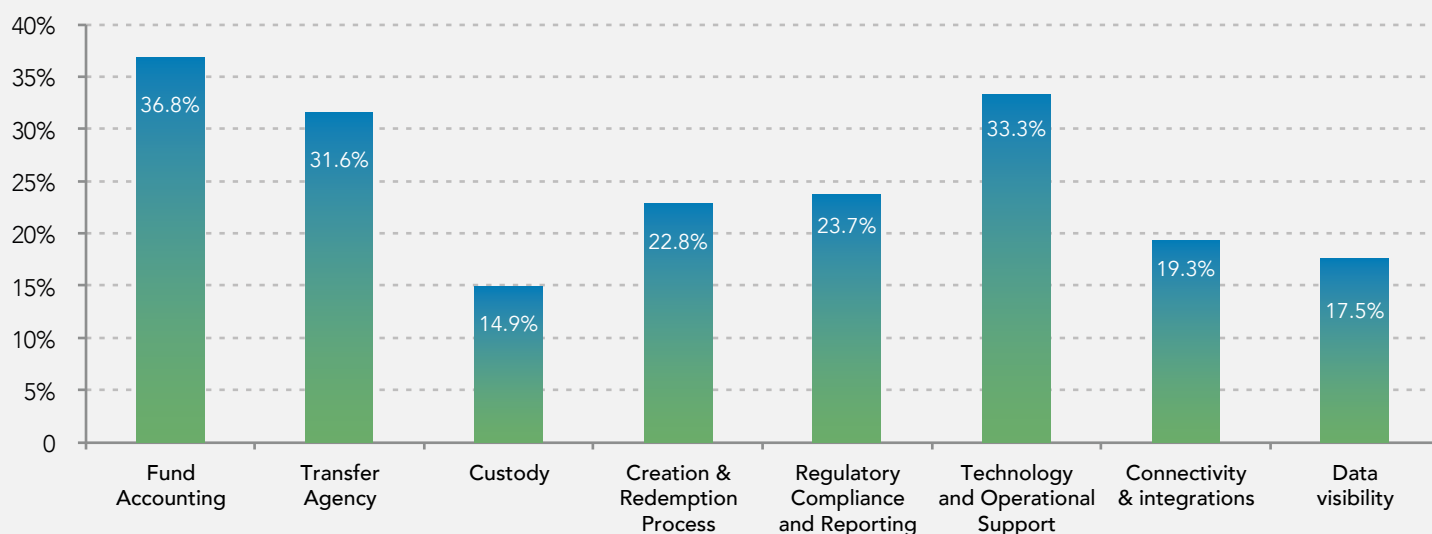


Figure 4

Just 22.8% of asset servicers told the Calastone research that enhancing the ETF creation and redemption process was one of their two main business priorities, putting it behind fund accounting, transfer agency, technology and operational support and regulatory compliance and reporting (Fig 5).⁴

What are the top two priority areas of ETF servicing that you are looking to make improvements in? (pick two)



⁴ Funds Europe – 2023 – ETF Administration survey and report

Figure 5



Improving the creation and redemption process is something asset servicers do need to work on, if they are to retain and win business moving forward. This will require providers to focus more of their resources on upgrading their systems - as opposed to continually re-investing in legacy technology or leveraging third-party solutions.

Equally, many ETF asset servicers are also coming unstuck due to the lack of standardisation in their service models and technology.

This is partly due to the highly complex nature of ETFs today.

As the industry becomes more esoteric, some issuers, for instance, are asking their asset servicers for highly customised solutions. While bespoke technology services may go down well with individual clients, the competing demands from customers can sometimes overwhelm providers, and may even impede scalability at a time when the wider ETF industry is expanding fast.

Instead of continuously developing tailored solutions on a client-by-client basis, asset servicers need to better standardise their underlying technology.

REGULATION DRIVES TRANSFORMATION

Ensuring greater automation and standardisation in the ETF creation and redemption process has been given a further impetus by recent regulatory developments - namely the introduction of the EU's Central Securities Depositories Regulation (CSDR) and the global rollout of shorter settlement cycles (i.e. T+1).

In the case of CSDR, cash penalties are being imposed on market participants for settlement fails, a provision that is having a disproportionate impact on ETFs, which tend to have higher fail rates relative to the underlying assets that they track.⁵ This is because APs do not always own a full basket of securities when pricing ETFs, and this can occasionally lead to late delivery.⁶

A CSDR Refit is currently underway, the outcome of which could usher in the introduction of mandatory buy-ins, if EU regulators believe that cash penalties have not done enough to improve settlement discipline.

Again, if these amendments do go through, then they will likely cause additional problems for APs.

Shorter settlement cycles could also prove challenging for the ETF industry.

Several countries - including the US, Canada and Mexico - are transitioning to T+1, while consultations about shortening the settlement cycle are underway in the UK and the EU.

Other countries are going a step further.

India has not only phased in T+1 for its securities market, but the local regulator is now talking about adopting a voluntary T+0 cycle in 2024, followed by instant settlements in 2025. Most people believe that settlements will eventually take place on T+0, and possibly even atomically within the next five-10 years.

According to Brown Brothers Harriman: "It (T+1) creates the potential for settlement mismatches due to timing discrepancies between ETF shares and the underlying basket trades tied to a creation/redemption order, as well as primary/secondary market settlement mismatches. These timing challenges will prompt changes to workflows and systems that support creations and redemptions, and an increased use of cash collateral and/or cash in lieu. Ultimately, the differences in settlement timing between the US and other markets could result in an increase in failed trades and wider trading spreads in the secondary market."⁷

CSDR and T+1 could have significant indirect cost implications for ETF investors, especially if the underlying asset servicing function is not properly automated.

5 & 6 ETF Stream – May 18, 2022 – CSDR increases pressure on authorised participants in fragmented European ETF market
7 BBH – September 14, 2023 – How T+1 impacts the global ETF ecosystem

KEEPING COSTS LOW FOR INVESTORS

Automation and standardisation will be integral to keeping costs low for ETF issuers and investors.

As the ETF market becomes more competitive, investors are scrutinising the total cost of ownership (TCO) at ETFs in greater detail and benchmarking the full cost of investing against other ETF issuers and mutual funds.⁸

The TCO at an ETF comprises of three different variables, including the total expense ratio (TER), liquidity costs, and tracking error. Liquidity costs relate to the bid/offer spread, namely the premium and discount of the ETF's tradable price in comparison to the value of its underlying assets.⁹

It is here where asset servicers (i.e. transfer agents, fund accountants, fund administrators and global custodians) are playing an invaluable support role, as they can facilitate efficiencies and mitigate risks in the primary market process. By helping APs in their remit as liquidity providers and arbitrageurs, asset servicers can drive down liquidity costs and the TCO for investors.¹⁰

8 & 9 Funds Europe – Counting the full cost of ETF Servicing
10 Funds Europe – Counting the full cost of ETF Servicing

INEFFICIENCIES NEED TO BE ROOTED OUT

In order to support the requirements of the ETF industry, manage regulatory changes and reduce the costs facing issuers/investors, asset servicers will need to allocate more resources into their technology systems and deliver on standardisation, the benefits of which can be passed downstream from ETF issuers to investors.

Forward-thinking asset servicers are turning to third parties to help them automate and standardise the ETF lifecycle in the primary market, which until recently has been a major gap in the market.

Calastone has filled this void with its ETF Servicing solution, a unique ETF administration platform which connects every participant in the ETF creation and redemption lifecycle, providing real-time processing and visibility of order management through to the underlying basket trading.

As more providers re-think their historic approach to technology, these sorts of solutions will become increasingly mainstream, enabling them to increase efficiency, minimise risk, and scale at reduced cost.

A number of providers are taking note.

HSBC Securities Services, for example, plans to deploy Calastone's ETF Servicing solution across its global ETF client base, including issuers domiciled in Ireland, Hong Kong, Singapore and Australia.

Automation and standardisation in asset servicing will help facilitate efficiencies in the creation and redemption process, thereby improving liquidity and shielding investors from added costs during these difficult market conditions.

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Our mission is to help the asset management industry transform by creating innovative new ways to automate and digitalise the global investment funds marketplace, reducing frictional costs and lowering operational risk to the benefit of all. Through this, we generate the opportunity for the industry to deliver greater value back to the end investor.

Over 4,000 clients in 55 countries and territories benefit from Calastone's services, processing £250 billion of investment value each month.

Calastone is headquartered in London and has offices in Luxembourg, Milan, Hong Kong, Taipei, Singapore, New York and Sydney.

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