More transparency equals more liquidity in ETFs

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For all the stories about the cost of implementing MiFID II, we are starting to see some tangible advantages emerging. Among them is improved liquidity in Europe's ETF market.

Until MiFID II came into force, much of the trade in ETFs was next to invisible.

Why?

Because there was no requirement for firms to disclose over-the-counter (OTC) trades.

Around 70% of ETF trades in Europe have typically been done OTC rather than on-exchange. Institutional investors have large ticket sizes – typically EUR 3.5m – and in Europe at least they are more comfortable trading OTC. The average on-exchange trade is less than EUR 500,000.

This lack of transparency meant it was very difficult to gauge the liquidity in a particular product. Now all trades are printed, irrespective of whether they have been done on-screen or OTC.

The upshot is that ETF liquidity appears to be better than many had realised. This is helping to feed demand – which in turn should boost liquidity further. It is also helping to reduce bid/offer spreads.

There are other factors at work, too. It is not just about MiFID II.

ETFs' broader role in securities lending

One important factor is the increasing acceptance of ETFs as collateral in lending programmes. A broader lending market also helps market-makers who know that if a trade fails they can borrow with relative ease.

Collateral usage has been facilitated by the international settlement structure for ETFs introduced by Euroclear in tandem with leading issuers two years ago. These are pan-European securities, often listed on three or four exchanges. By replacing localised settlement with an ICSD model, it has made it simpler for the big investment banks involved in lending to locate and manage their inventory.

Around 41% of Europe's ETF market, by value, is now in the international structure. Interestingly, 73% of the Irish market is now in the international model. And, the Irish market comprises 54% of the overall European market.

The great thing is that the international issues have eliminated much of the friction – the effort needed to realign trading books by shifting holdings from one CSD to another – that was limiting growth.

The retail factor

The other big factor I see is mounting retail interest. This is in part down to MiFID II, which is encouraging more platforms across Europe to list ETFs alongside mutual funds – something that Euroclear's FundSettle has done for some time.

Read our retail ETF report featuring Winterfloods, BlackRock and SPDR on:

euroclear.com/RetailETFs

Given the transparency requirements of MiFID II, this allows retail investors and their advisers to see at a glance the cost difference between most mutual funds and ETFs. Even after a reduction in the cost of many passive mutual funds, this is still a plus for ETFs.

In a recent article, Cerulli Associates pointed to another factor helping to drive retail interest: the development of fractional trading in ETFs.

The high price of many ETFs has been an obstacle to their inclusion in smaller model portfolios managed by advisers.

"The need to trade in whole ETF shares presented problems for some model portfolios, but with fractional trading, switching is more straightforward," said Cerulli.

Now a number of firms are offering to trade in fractions of an ETF, effectively warehousing the 'leftovers' in a residual, internal account. One of them, Winterfloods, was quoted by Cerulli as seeing 'real demand' for fractional trading both from traditional adviser platforms and from robo-advisers.

This is also a liquidity booster of sorts, opening ETFs up to relatively modest regular savings plans across Europe.

There is a long way to go before the retail market in Europe matches the 40% share of ETF trading it holds in the US. But this is a step in the right direction.