ETFs 2018: regulatory focus on value for money

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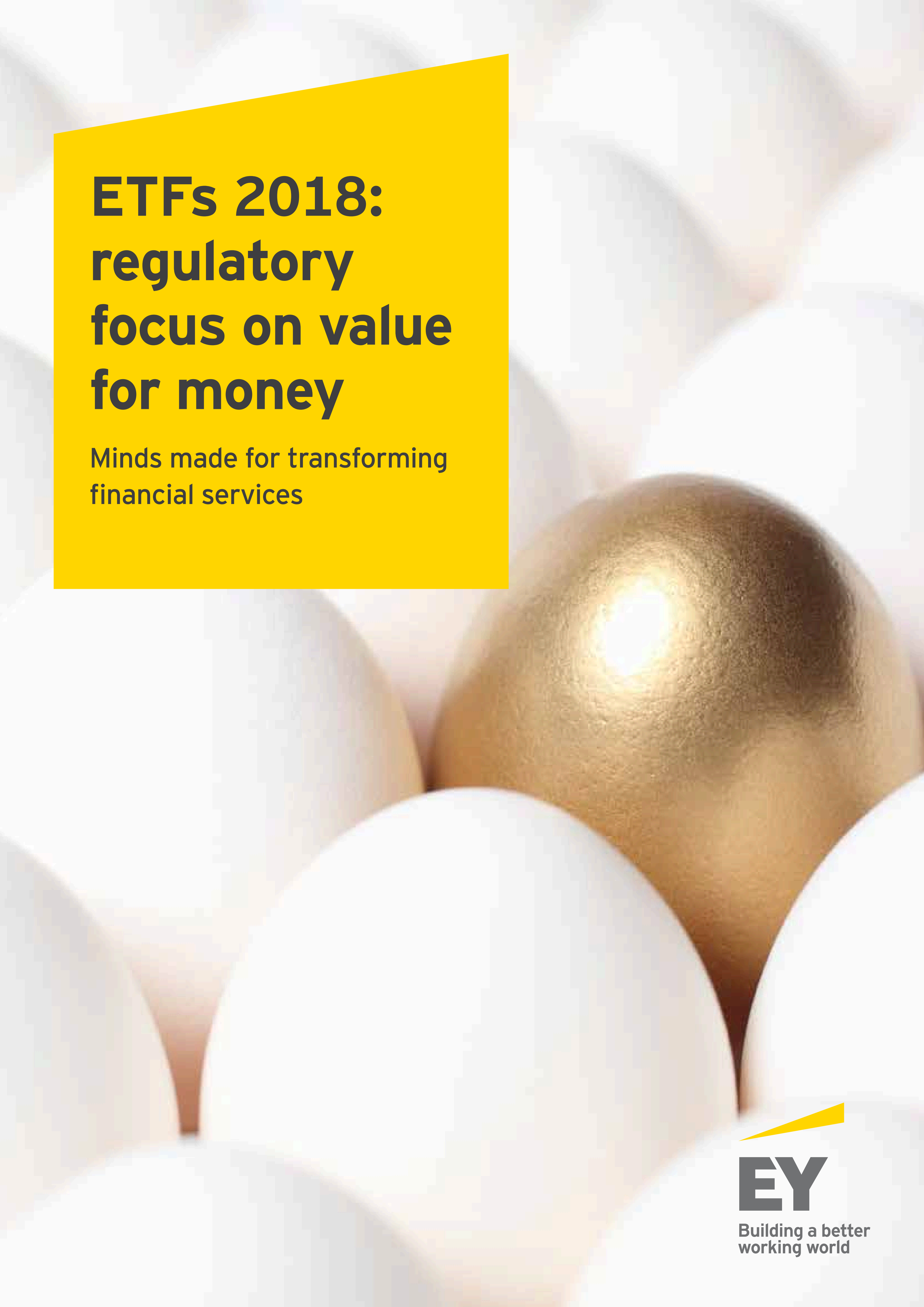

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Introduction to EY's 2018 ETF article series

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Overall growth

In 2018, we have seen the exchange-traded fund (ETF) industry continue to go from strength to strength. In the year to date, ETF and exchange-traded product (ETP) assets increased by almost US$300 billion globally to over US$5.1 trillion, representing a 10-year compound annual growth rate (CAGR) of 18.9%. The industry continues to launch more and more products, with over 7,400 active products across 339 promoters.

The inflows that we have seen to date in 2018 are continuing the trend of previous years. Although not as exceptional as in 2017, we are seeing inflows across the board. Interestingly, we have already seen inflows into active ETFs significantly exceed last year. Equity continues to lead the way with inflows of US$177 billion up to July 2018.

New players

The flows in the market, as well as the growth potential and the additional benefits that ETFs can offer to distribution, mean that new players continue to enter the market. There are now 34 promoters with assets in excess of US$10 billion, while several new players have gathered significant assets. Though core products are highly competitive, there are ample opportunities for new and innovative ideas.

Active ETFs

Active ETFs continue to grow, albeit from a low base. These funds gathered over US$21 billion in 2018, building on the US$24 billion gathered last year – a continued growth trajectory. However, the active ETF industry is still focused on certain regions and it may take time for active ETFs to gather momentum.

Regulation

As the industry continues to grow and evolve, there is an increasing focus on ETFs from regulators. This is a positive trend and the industry can capitalize on it to highlight the benefits of ETFs to the end investor. This is particularly true, when we consider the value-for-money proposition of ETFs.

In Ireland, September 2018 saw the Central Bank of Ireland (CBI) issue a feedback statement on its well-received ETF discussion paper of 2017. The statement permits the creation of ETF share classes of regulated funds – a positive step for the industry. However, it does not conclude the CBI's focus on other areas – such as transparency requirements for active ETFs – acknowledging that a consistent European framework is needed. The U.S. Securities and Exchange Commission (SEC) has also considered ETF-specific rules in the US and, in France, the Autorité des marchés financiers (AMF), also known as Authority of Financial Markets, released a paper on liquidity risk in 2017. The International Organization of Securities Commissions (IOSCO) is also looking at some of the specific issues in the industry, focusing on themes such as liquidity (identified as possible concerns by a number of regulators).

While a global solution to some of these issues, such as active transparency, would be difficult to achieve, a good alternative would be regional solutions. On that basis, the industry can grow and evolve in new ways.

Opportunities to grow

Although promoters are always looking for suitable new products, new markets are also emerging that may be very appealing. Entry into the Chinese market, in particular, could benefit the global industry if the right access and distribution frameworks can be created.

Operating model

To facilitate all that the industry wants to do, operating models will need to adapt and evolve. Organizations are already focusing on this and it is vital that they continue to do so if the industry has to reach its potential.

Can ETFs be more successful than other funds if value is about more than price?

Value for money in ETFs: it's not just about price

New regulations will challenge ETF providers to demonstrate leadership on value, not just price

ETF providers have both benefited from, and contributed to, the global push for investor value. But the ***Asset Management Market Study*** published by the UK's Financial Conduct Authority (FCA) will have a greater effect on the industry than many providers realize. In time, its effects are also likely to reach beyond the UK.

Should ETF providers be worried about this new push for investor value? Are they ready to capitalize on this important change? And what actions should they be taking?

In this article, we aim to answer these questions and show that the regulatory focus offers ETF promoters an opportunity to strengthen their reputation for investor value. In contrast, inaction could carry significant risks.

The value agenda — friend or foe?

The push for greater value has been a defining theme of the global investment industry over the past few years. On one hand, a decade of low yields has strengthened investors' determination to reduce costs. On the other hand, major regulatory initiatives, such as Markets in Financial Instruments Directive II (MiFID II) and Packaged Retail and Insurance-based Investment Products (PRIIPS) regulation have increased transparency requirements around the charges for investment products and services.

This value agenda has been an important tailwind behind the ETF industry's remarkable growth. ETFs' total expense ratios are typically lower than for comparable mutual funds, and they continue to fall. So, it's no surprise that many ETF providers welcomed the UK's recent *Asset Management Market Study (AMMS)*. Looking at the UK investment market as a whole, the *AMMS* found significant evidence of a lack of competition.

Even so, we think it would be a mistake for ETF promoters — in the UK and elsewhere — to underestimate the implications of this landmark study. The *AMMS* presents a number of challenges to the ETF industry, and it won't be the last word in the debate over value. ETF providers need to ensure they understand the evolving shape of regulatory thinking and that they are ready to respond.

Why the market study matters for ETFs

The final report of the *AMMS* was published in June 2017 and a policy statement setting out proposed remedies appeared in April 2018.

The study's overall aim was to ensure that the asset management market works well and that investment products provide consumers with value for money. It identified a number of significant shortcomings in the UK's asset management market, especially, in relation to retail investors — both advised and non-advised.

In particular, the *AMMS* found that asset managers generally give insufficient consideration to whether they deliver value for money and that investors are often overcharged. Commercial pressures were seen as insufficient to ensure price competition at the point of sale, with fund governance bodies failing to exert sufficient pressure on post-sale costs.

At first glance, ETF providers may feel these findings are of little relevance to them. After all, ETFs have a strong track record of reducing costs and increasing retail accessibility, and EY research indicates that they already offer good value for investors.

Furthermore, according to a research carried out by EY in 2018, providers believe there is further scope for an overall reduction in management fees over the next three years. And in any case, the majority of European ETF investors are institutions — a group that the FCA found to be served better by the asset management market.

That's an understandable view. But a closer look at the *AMMS* shows that several of its findings are highly relevant to the ETF industry. For example, the study found that:

- **Investors see costs as important, but often do not understand them well.** FCA research suggests that 45% of retail investors consider charges to be an influential factor in their choice of fund, but that an alarmingly high 22% are "not sure" whether they are paying fund charges.
- **Investors rely heavily on best-buy tables, despite their limitations.** Morningstar© ratings, which provide quantitative, risk-adjusted comparison of past performance net of costs, are particularly influential. These ratings are agnostic between active or passive funds, which can result in inaccurate comparisons when selecting index-based investments.

The existence of these gaps in investor understanding should be a concern for ETF providers hoping to attract retail inflows. That's especially true given the irrelevance of past performance in determining the suitability of passive investment products.

Value assessments: a new challenge

If ETF providers should take note of the *AMMS*'s findings, it is "very" important they understand the remedies outlined in the FCA's subsequent policy statement. In particular, a plan to strengthen the existing duty to assess investor value — the so-called value-for-money assessment — will require providers to:

- Assess value over the life of an investment, not just at the point of sale.
- Consider value for end consumers, including those represented by institutions.
- Incorporate all investor costs within the fund, such as indexing and hedging costs that could be interpreted as inclusion of tracking error for ETFs; transaction costs external to the fund, such as brokerage charges that are hard to obtain will also need to be disclosed.
- Look beyond costs and consider suitability when assessing the value of investor outcomes.

Given the ETF industry's track record of cost reduction, providers may be tempted to assume that they already comply with this proposal. But the new requirements will force providers to revisit factors, such as the value eroded by trading costs, the relative merits of index construction, and the degree to which stock lending income is used to offset fund costs.

The new remedies also create significant practical hurdles. In particular, promoters must conduct value assessments of every fund in their range from September 2019 onward. The FCA has not defined what constitutes "value," but promoters will need to:

- Consider a non-exhaustive list of factors, including performance versus expectations, the split of costs and benefits between agent and investor, and the value of services purchased on behalf of investors.
- Conclude that each fund offers good value or take corrective action if it does not.
- Explain the assessment annually in a publicly available report.

ETF providers may already work hard to educate clients about the performance and suitability of their funds, but this effort will now need to take place within a formal framework. The scale of the challenge is illustrated by the growth of smart beta and multi-factor ETFs. How will promoters demonstrate the value of these products?

How prepared are ETF providers — and how should they respond?

Our conversations with leading ETF promoters on this topic suggest that the ETF industry is firmly in favour of any measures aimed at enhancing investor value.

Even so, it seems that most ETF providers have not yet developed a formal framework that will allow them to conduct value assessments and demonstrate compliance with the *AMMS*' proposals. EY research indicates that only a small proportion of ETF providers have a value-for-money framework in place, suggesting that many firms have a long way to go in this area.

We see potential risks to the industry from failing to respond appropriately to the *AMMS* and its proposed remedies. Conversely, we think the *AMMS* gives ETF providers a valuable opportunity to enhance their contribution to the value agenda. In the process, they could strengthen their competitive position within the asset management market.

Seizing this opportunity will not only require promoters to take a robust approach to meeting the FCA's requirements. It will also require firms to demonstrate leadership on investor value — and in related areas, such as transparency. In our view, these are some of the most important areas of action for promoters to consider:

Quick route to action — demonstrating leadership on investor value

- Obtain more data on market flows to help facilitate analysis of market activities.
- Improve transparency over the securities lending and collateral activities of ETFs beyond the requirements of the guidelines issued in 2014 by the European Securities and Markets Authority (ESMA) on Undertakings for the Collective Investment of Transferable Securities (UCITs) ETFs.
- Improve investor experiences, especially via provider websites, to support the retail growth agenda.
- Provide more education for investors and intermediaries.
- Demonstrate why smart beta and other innovative products offer value for investors compared with other investments.

Is the *AMMS* only the beginning?

This issue is not only crucial for ETF providers with an existing or planned presence in the UK market. In time, the FCA's decision to take an assertive stance on investor value could influence, or be copied by, other regulators.

That is particularly true in Europe, where high standards for costs, charges and suitability are set via MiFID II. Irrespective of the future relationship between the UK and the EU, we would expect the FCA to continue to set very high standards for investor protection. The recent ESMA paper on applying UCITS standards also shows that European authorities will continue their focus on costs and disclosure.

In the longer term, the wider adoption of value assessments could have far-reaching global implications for the global ETF industry, especially, in major retail markets, such as the US, Canada or Australia.

To stay ahead, the ETF industry needs to keep moving

The debate on investment value is evolving rapidly. The strengths of ETFs as a low-cost investment vehicle must not be allowed to give promoters a false sense of security. Value is about much more than management fees.

The UK is currently driving the agenda by requiring providers to demonstrate that they deliver value. Promoters in the UK need to understand the full implications of the new requirements and ensure they're ready to demonstrate that they have performed the value assessments.

Looking ahead, firms should consider how the FCA's actions and the wider value agenda could impact operating models around the world. The largest firms in the industry should consider developing global frameworks that follow best practices in demonstrating value for money.

Ultimately, this may require the ETF industry to adapt its cultural focus on low management fees into a more holistic approach toward investor value. The industry has consistently been ahead of the curve on costs, but will need to demonstrate fresh leadership if it is to fulfil its long-term retail ambitions.

Summary

The *AMMS* presents challenges and opportunities for ETF providers. The industry has a chance to take the lead in demonstrating how the ETF vehicle can deliver value for investors.

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To discuss how EY can help your business thrive in the ETF space, please contact one of the authors or your local EY office.

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