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Brexit and ETF Migration: Countdown to March 2021

The value of ETFs issued globally was almost €5 trillion at the end of 2018—making them one of the greatest success stories in the investment world in recent decades. Although the US still dominates the ETF market, 15% of global asset value is now attributable to European ETFs. And European ETF assets under management have increased more than six-fold in the past decade.[1] Brexit is set to have significant implications for European ETFs, and especially for Irish ETFs.

Ireland has long been Europe's leading ETF market, with approximately 60% of all European ETFs domiciled there, valued at around €430 billion ($480 billion equivalent).[2] Ireland's issuing and settlement services are operated by Euroclear UK & Ireland (EUI), with the vast majority of Irish ETFs currently listed on the London Stock Exchange. The expected departure of the UK from the European Union means that EUI will no longer be able to provide issuer Central Securities Depository (CSD) services for Irish securities as of April 2021.

This paper outlines the anticipated migration of these services to a new CSD, and the potential for adoption of a new model (International Central Securities Depository, or ICSD). Both changes will profoundly affect ETFs and their managers. This paper highlights some of the challenges that ETF managers may need to be aware of, provides details about the practicality of the migration, and outlines distinctive features of the ICSD model.

What is happening and when?

Following Brexit, the UK may lose its EU financial services passporting rights that allow UK-based firms to provide certain financial services to EU-domiciled firms. Consequently, EUI may no longer be able to act as issuer CSD for Irish equities and Irish ETFs. "We have been working with the Irish market and the authorities to define an alternative," says An Mestdagh, Director Product Management at Euroclear.

A decision, supported by the Irish market and authorities, will move issuance of Irish ETFs and Irish corporate securities to Euroclear Bank in Belgium. The European Commission has granted an emergency equivalence to EUI to continue to settle under existing structures until March 2021; this will be valid even if the UK leaves the EU without an agreement before that date. However, the emergency equivalence arrangement cannot be extended, emphasises Mestdagh.

Euroclear has been involved in intense discussions with the market and the authorities about the scale of the migration and the challenges it presents: UCITS ETFs must apply for a Scheme of Arrangement to move to a different issuer CSD. While 80% of the $480 billion Irish ETF market is already issued using the ICSD model, that still leaves the potential migration of more than $100 billion of ETFs, according to Euroclear.

> "It would be a first for an entire European equity market to change issuer CSD at once and consequently complex to organise and manage the risks in a clear and appropriate way," says Mestdagh.

Euroclear's aim is to mitigate operational, market and systemic risk as much as possible.

[1] https://www.clearstream.com/resource/blob/1525860/099a709982d35105f16e10a33dc2f15e/study-clearstream-innovative-solutions-etf-market-data.pdf

[2] https://www.irishfunds.ie/news-knowledge/news/press-release-assets-in-irish-domiciled-funds-reach-all-time-high-of-2.64-trillion-irish-funds

While Euroclear recognises that there are existing legal mechanisms under Irish law such as Schemes of Arrangement, it believes the risks associated with an entire market migration using these mechanisms are significant. “As a result, we are discussing with the authorities the potential to enact legislation that would facilitate a more streamlined migration of securities to Euroclear Bank,” says Mestdagh. “The authorities have noted the preference of Euroclear and the market [to facilitate a more streamlined migration] and are analysing in depth the potential to enact legislation.”

€5 TR	15%	80%
in global ETFs were issued in 2018	of global asset ETF value is attributable to European ETFs	of $480 billion Irish ETFs are issuing in the ICSD today

What options are open to ETF issuers?

ETF issuers will have the option to use a domestic model or an international model (known as iETF), which uses the ICSD model with a common depository. What should determine their choice? For issuers serving a single market, a domestic model may make sense.

> “For issuers with distribution strategies that cover multiple exchanges, the iETF model is more efficient,” says Mohamed M’Rabti, Director and Deputy Head of Funds at Euroclear.

ETFs traded on multiple exchanges are fungible across them. This creates challenges because ETFs are treated as a local equity for post-trade arrangements and consequently settle in the local CSD. However, because of their fungibility they need to move from one CSD to another, resulting in a need to realign positions to meet inventory requirements on another exchange. This realignment process is manual, complex and risky.

Cross-border transfers are further complicated by the myriad permutations of ETF and issuer; while some have the same issuance or market, others have separate issuance; equally, settlement can occur in a number of locations. This web of complexity has necessitated the establishment of a database to enable broker-dealers to understand the requirements for moving a particular ETF.

Long timeframes for realignment of ETFs from one CSD to another have additional repercussions, such as potential settlement fails and consequent buy-ins.

> “If a broker-dealer is unable to move an ETF in the required time, the local central counterparty clearing house can impose a buy-in charge,” says Tom Ahern, Global Head of Relationship Management for BNY Mellon Corporate Trust.

To avoid such costs, market-makers traditionally maintain inventory in each market so that trades cannot fail. However, this is operationally inefficient and increases costs, resulting in wider bid-offer spreads for end buyers and potentially reducing liquidity.

How does the ICSD model work?

To overcome the post-trade challenges for ETFs listed on multiple exchanges, Euroclear created iETF in December 2013. It replicates the US approach, where settlement takes place in a single location using the ICSD model.

ETFs issuing in the ICSD model have numerous benefits for fund managers, eliminating many of the challenges associated with domestic settlement. “Issuers are constantly trying to lower costs and we are one component among others that is helping to achieve that,” says M’Rabti. The use of a single settlement location reduces errors and the need for multiple International Securities Identification Numbers. The set-up process is smoother, especially for German ETFs, notes Ahern.

Most importantly, iETF lowers operational costs as people are no longer required to manage transfers. “As ICSD does not require broker-dealers to maintain local inventory, it reduces operational risks, improves liquidity and lowers bid-offer spreads,” adds Rosa Scappatura, Head of ICSDs Relationships for BNY Mellon Corporate Trust.

In addition, iETF has a large settlement window, which allows settlement even if local CSDs are closed. This gives market-makers greater flexibility, as around 70% of the ETF market is traded OTC. iETF also offers a multicurrency platform with 54 currencies, enabling issuers to create currency-hedged ETFs for local investors. “Finally, centralisation of settlement results in greater visibility of inventory and therefore facilitates increased securities lending,” says M’Rabti.

What do ETF managers need to consider?

Although discussions with the Irish government are underway to potentially enact legislation that would facilitate a more streamlined migration of securities to Euroclear Bank, ETF managers should not take a wait-and-see approach. “Given that legislation cannot be guaranteed and also presents certain risks, each issuer is encouraged to review its own migration possibilities and plan accordingly,” says Mestdagh.

The migration of the 1,115 Irish securities and ETFs currently settled by EUI[3] to Euroclear Bank must be completed by March 2021. But for ETFs moving to the ICSD model it will begin earlier and take place gradually, in order to ensure a smooth process.

“That means ETF managers should start to plan their approach as soon as possible,” says Scappatura. “Ongoing uncertainty about the date of Brexit should be ignored. As things stand currently, the migration to Euroclear Bank will occur regardless of any change of heart by the UK.”

TARGET2-Securities (T2S) is also a red herring in this context. T2S is a valuable effort to harmonise cross-border settlement in Europe and has enhanced the capabilities of local depositories to support European ETFs. However, T2S covers only euro and Danish krone settlement; US dollar and sterling are not included and are unlikely to be in the future. Consequently, T2S is not an alternative to the ICSD model for Irish ETFs, the majority of which are denominated in sterling or US dollars. That means that for ETFs listed on multiple exchanges, the ICSD model is likely the most suitable option.

What progress have ETF managers made in preparing for migration? To date, a number of large ETF managers have proactively acted on the challenges prompted by migration to Euroclear Bank, according to Scappatura. “Some have already made the decision to go to ICSD and a handful migrated between the end of last year and the first quarter of 2019,” she says. “Other funds are set to launch using the ICSD structure in the coming months. However, some players seem to be waiting for further developments and appear to be less engaged.”

While some ETF managers are waiting for potential changes by the Irish government, BNY Mellon’s experience with multiple migrations to the ICSD model shows that six to eight months is required for the process to complete. Working backward from the expected migration date for the affected ETF securities[4], ETF managers should begin migration in early 2020. “That means consideration of the various issues and preparations needs to begin soon,” says Scappatura.

Time is of the essence because of the need to evaluate migration options and allocate resources accordingly. Moreover, ETF managers need to engage with several stakeholders, including their administrator, paying agent, relevant exchanges, central counterparty clearing houses and market-makers and ICSDs such as Euroclear.

ETF managers should be reassured that the ICSD model has been in operation since 2013, and the migration path from local CSDs is tried and tested. “While there are costs, these are known and the processes and mechanisms deployed are proven to result in limited disruption to investors,” says Scappatura.

Leveraging industry expertise

BNY Mellon offers solutions that span the entire ETF lifecycle; from fund administration and custody to paying agent and common depository in the ICSD structure. BNY Mellon has been active in the European ETF market for almost 20 years—since the genesis of the market. The bank works with a large number of issuers and funds and has long experience of both the market’s settlement challenges and in developing the ICSD solution to address these challenges.

“Crucially, BNY Mellon is one of the very few service providers that can act as both a payment agent in the ICSD structure, and a custodian/fund administrator,” says Rob Rushe, Head of ETF Services at BNY Mellon in EMEA.

“Working with a single provider for both functions can result in a streamlined and efficient service because they are under the same roof, which reduces operational risks such as payments delays, and improves reconciliation of records, which is a key regulatory requirement under the Central Securities Depositories Regulation.”

BNY Mellon’s broader capabilities in the depository market also provide reassurance to clients. The bank is one of the largest common depositories in Europe, with a 25% market share for Eurobonds and €2.7 trillion of assets.

[3] https://www.euroclear.com/content/dam/euroclear/About/regulatory-landscape/EuroclearBankWhitePaper-DeliveringcontinuityofIrishsecuritiessettlementinthelongtermpostBrexit.pdf

[4] https://www.euroclear.com/content/dam/euroclear/About/regulatory-landscape/EuroclearBankWhitePaper-DeliveringcontinuityofIrishsecuritiessettlementinthelongtermpostBrexit.pdf

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