PRIIPs Transaction costs seminar

Michael Collins
Karen Jones

14 January 2019

Agenda

- Context
- Legislative background
- Calculating transaction costs
- Policy issues raised
- Supervisory findings

Context

- Why are we talking about transaction costs?

What are transaction costs?

- Costs associated with transactions in investments

- Costs of entering or exiting an investment
- Costs of transactions within an investment vehicle

- Defined in UK pensions legislation as the costs of "buying, selling, lending or borrowing investments"

Why do transaction costs matter?

- Some types of costs:
  - You pay someone
  - You know how much you are paying them
- Transaction costs:
  - You (or someone acting on your behalf) acquire an investment
  - This has costs attached to it
  - These costs may be contained in the amount paid for that investment

- Not always transparent to the party undertaking the transaction
- Generally not transparent to any end consumer

Legislative background

- Why are there rules on transaction cost disclosure?

Why do they need to be disclosed?

- A number of legislative acts require the disclosure of indirect costs
  - PRIIPs regulation
  - MiFID II
  - UK Pensions Act 2014
- All contain high-level requirements to disclose transaction costs
- Detailed rules underpin high-level requirements

How do they need to be disclosed?

- Product or distribution?
  - PRIIPs and pension rules focus on products
    - Detailed calculation methodologies to deliver standardisation
  - MiFID II focuses on distribution
    - No detail on how to calculate costs of underlying products (these are contained in the product disclosure)
- Who is the audience?
  - PRIIPs focuses on retail consumers – single number disclosed with no contextual information
  - MiFID II cost disclosure to all clients
  - Workplace pension disclosures to pension governance bodies (trustees / IGCs) – breakdown into major elements and contextual information required

Where can I find the rules?

- Transaction cost calculation rules contained in Annex VI of the PRIIPs RTS (EU Regulation 2017/653)
- Rules on presentation in Annex VII
- Two different methodologies
  - 'Arrival price' (VI points 9-20)
  - 'New PRIIPs' (VI points 21-23)
- Specific issues to note
  - Costs for transactions in other PRIIPs (VI points 5 (l)(iii) and (m)(iii))
  - Anti-dilution mechanisms (VI point 11)

Where can I find the rules?

- COBS 19.8
  - Calculation methodology largely the same as PRIIPs
    - Some minor clarifications around real assets / child orders
  - Additional information required:
    - Stock lending / borrowing costs
    - Contextual information
    - Break-down of explicit cost elements
- MiFID
  - Article 50 of MiFID Delegated Regulation (EU) 2017/565

Other regulatory requirements

- Best execution
  - Most transactions subject to best execution rules
  - MiFID II introduced some more prescriptive elements, in particular for OTC transactions
  - Transaction cost disclosure is not the same as best execution
- Record-keeping
  - Data on orders and transactions needs to be recorded and retained for 5 years
  - Most data for transaction cost disclosure must be kept under record-keeping rules

Calculating transaction costs

- How should transaction costs be calculated?

How can transaction costs be calculated?

- Two types of cost:
  - Explicit
    - Costs that someone is being charged
    - For example, commissions, taxes, advisory fees
  - Implicit
    - Costs that are part of the transaction price

- Explicit costs straightforward to identify
- Implicit costs more difficult
- Two ways of assessing implicit costs:
  - Calculation of actual costs
  - Estimation of costs using standardized numbers

- These methodologies are suitable for calculating transaction costs at portfolio level, not at individual trade level

Estimation methodology

- Spread-based
  - Typically calculated by multiplying portfolio turnover rate (PTR) by a standardised spread
- Advantages
  - Intuitively simple at the level of individual transactions
  - Can require a limited number of calculations
- Issues
  - Typically generic – no differentiation between different types or sizes of transaction, or between different transaction approaches
  - Does not reflect actual costs incurred
  - Omits cost of dealing in institutional size
  - Relies on judgements of product provider
  - Calculation of PTR not trivial

Calculation methodology

- Implementation shortfall
  - Costs calculated as difference in return of actual portfolio relative to a ‘zero-cost’ theoretical / paper portfolio
- Advantages
  - Comprehensive calculation of costs
  - Provides information on actual costs
  - Hard to ‘game’
- Issues
  - Relies on some theoretical assumptions
  - Relies on availability of ‘live’ market data
  - Contains costs which could be seen as theoretical

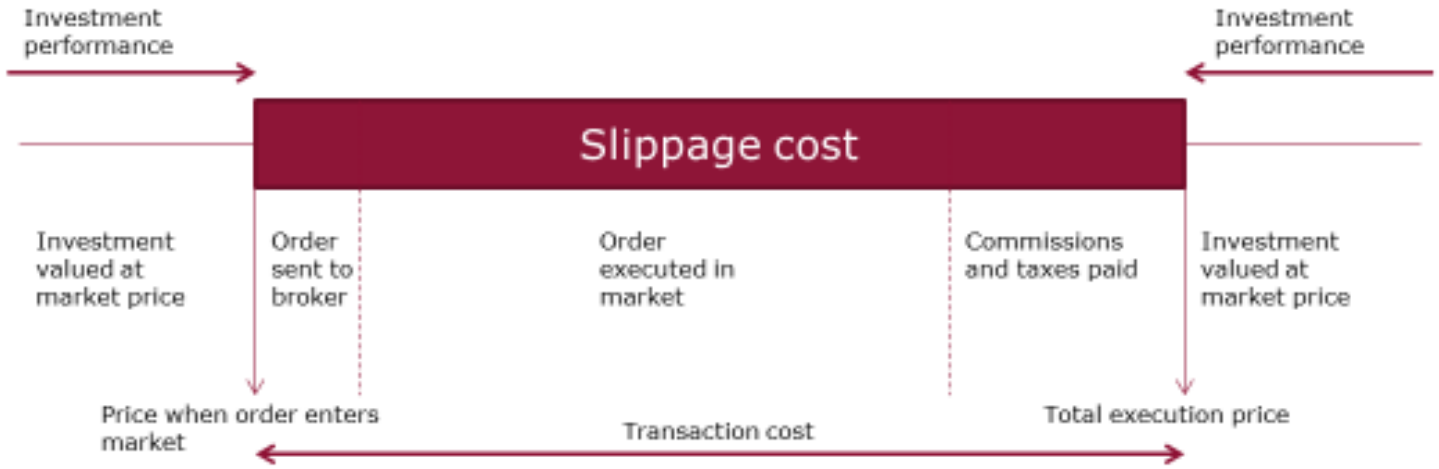
Slippage cost

- Slippage is a modified version of implementation shortfall

- Implementation shortfall
  - includes all costs once a decision to deal has been taken
  - includes opportunity cost of not dealing

- Slippage
  - does not accrue costs until an order has been transmitted for execution
  - includes only the cost of executed transactions

Illustration of slippage costs



Nature of calculations

- Slippage is a model to calculate transaction costs over time for a portfolio
- Output intended to be viewed at aggregate level
- This is not a flaw in the methodology, but the basis on which it works

Some issues that have been raised

- Inclusion of market movements
  - Market movements are a random (noise) element that affect each transaction
  - This is why transaction cost disclosure is based on transaction data over a period of time
  - Based on data we have reviewed, a typical equity fund transacts about 2,500 – 5,000 orders over 3 years.
  - The estimation error of transaction costs can be calculated, assuming a level of equity market volatility and the time taken to complete the average order
  - Assuming equity market volatility of 16% and an average time to transact of 2 hours, the estimation error is less than 1 basis point per annum

Some issues that have been raised

- Negative costs of individual transactions
  - A proportion of trades would be expected to have a negative transaction cost at the level of the individual transaction
  - This is because the market noise component for the individual transaction leads to a net negative
  - Depending on the actual costs and the level of market volatility, there might be 30-40% of individual transactions with negative costs

Some issues that have been raised

- Different transaction strategies
  - Transaction cost disclosure not a substitute for best execution policies and monitoring

- Stability of output
  - Some variability in transaction costs over time to be expected based on e.g. changes in market conditions

Supervision cross-firm review

Transaction cost implementation by asset managers

What

- PRIIPs & MiFID II implementation
- Calculation of transaction costs

Who

- Focus on anomalous transactions costs (negative, zero or highly positive)
- Sample of 16 asset managers

How

- Collected calculation methodology and raw data from sample firms
- Reviewed calculations to check accuracy

Supervision cross-firm review

Observations and outcomes

Incorrect use of arrival price methodology in relation to new issues

Inappropriate use of anti-dilution levy

Some **anomalously high transaction costs** were justified in light of trading strategies (eg high turnover portfolio)

'Zero' transaction costs traced to classification of relevant costs as 'other ongoing costs' (eg underlying CIS transaction costs)

Negative transaction costs were the result of incorrect application of PRIIPs calculation methodology

Questions



FCA Head Office
25 The North Colonnade
Canary Wharf
London E14 5HS

www.fca.org.uk