BVI

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Adaptation of the calculation methodology for transaction costs under the PRIIPs Regulation: suggestions by BVI[1] and EFAMA

Pending adaptation of the PRIIPs calculation methodology for transaction costs, fund investors will receive two diverging cost disclosures once the PRIIPs Regulation will become applicable to investment funds. This is due to the fact that the PRIIPs Level 2 provisions are incompatible with the MiFID II requirements. The “arrival price” methodology currently stipulated in annex VI para. 12 to 20 of the PRIIPs RTS systematically treats as a cost factor market movement in the price of an asset between the time of order submission and order execution. Such market movement is therefore reflected in the transaction cost calculations. Unlike the PRIIPs RTS, Level 1 of MiFID II and IDD requires that only costs “not caused by the occurrence of the underlying market risk” be aggregated and disclosed to clients[2]. Hence, transaction cost figures calculated in accordance with the current PRIIPs methodology cannot be legitimately used for the purpose of cost disclosure under MiFID II and IDD. This is especially obvious in many cases where market movement leads to an understatement of costs if compared with actual identifiable charges. In practice, transaction costs are therefore being calculated differently for the same fund for PRIIPs and MiFID II purposes which is problematic today, but will become unbearable once investment funds will be bound to produce PRIIPs KIDs and both diverging figures will be disclosed to investors at the point of sale.

Therefore, in order to facilitate provision of consistent and comprehensive cost figures to fund investors, it is key that the transaction cost methodology is adjusted by eliminating any impact of price movements on the PRIIPs calculations. This aim can be achieved by making the following targeted improvements to the ‘”arrival price” methodology which are also promoted by EFAMA[3]:

1. Shift of timing for determining the “arrival price”

The point in time at which the mid-market price of an investment ("arrival price") needs to be determined should be shifted from the time when the order is transmitted to the broker to the time of order execution.

Reasons:

- This measure would eliminate the impact of market movement in the price of an asset between transmission and execution of an order on the calculation results. This in turn would largely prevent the occurrence of negative transaction costs.

- Removing the influence of market movements on the calculations would render the results compliant with the provisions of MiFID II and IDD. Transaction costs calculated according to such amended “arrival price” method could then also be used for cost information at the point of

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Fund companies act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI’s over 100 members manage assets of more than 3 trillion euros for private investors, insurance companies, pension and retirement schemes, banks, churches and foundations. BVI’s ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

[2] Cf. Art. 24 (4) 2nd subparagraph of MiFID II, Art. 29 (1) 2nd subparagraph IDD.

[3] Cf. „EFAMA’s suggestions to address the PRIIPs KID’s shortcomings” from 10 September 2018.

sale. A uniform approach to determining transaction costs under PRIIPs, MiFID II and IDD will enhance the comprehensibility of transaction cost figures for both distributors and investors and contribute to an overall consistent cost disclosure.

- Market movement (also called “slippage”) is not recognised as a cost under the PRIIPs framework. Conceptually, PRIIPs requires taking into account “payments to third parties to meet costs necessarily incurred in connection with the acquisition or disposal of assets” (cf. annex VI para. 5 j)). Such payments can be explicitly charged when executing transactions or implicitly included in the bid and ask spread. The impact of market movements on the quality of execution is being captured and analysed in the context of "best execution", but is not related to costs.
- The impact of market movements is strongly dependent on the trading strategy: For a fund manager, it is possible to place a limit order with the broker for the purchase of a share or to monitor the market and only commission the broker when the desired price level has been reached. In both cases, the price of the share would be identical, while the transaction costs could display significant variations under the current arrival price methodology.
- There are currently major problems in obtaining information about the timing of order transmission to the broker (so-called order transmission time stamp) when the portfolio management for a fund is delegated to a third party. Absent these timestamps, fund managers must calculate “arrival price” costs by using the opening prices of the trading day or the closing prices of the previous day (cf. Annex VI para. 15 of the PRIIPs RTS). The calculation results are then potentially distorted by the price movement during an entire trading day. The information about the timing of order execution (so-called order execution time stamp) is easily available and already being provided by external portfolio managers on a trade-by-trade basis.

2. Recourse to half average spreads for transactions in illiquid assets

In the case of illiquid assets for which no intraday market prices or no market prices in general are available, the use of average spreads should be allowed as a basis for transaction cost calculation. The same should apply to transactions where the available mid prices are inaccurate or not representative for the specific trade.

Reasons:

- The arrival price methodology relies upon the availability of intraday market prices as a basis for calculation. For many less liquid securities which are only occasionally traded on the market, such intraday prices are not available. This pertains to some niche market segments, such as small cap shares or emerging markets corporate bonds. Regarding OTC derivatives which are negotiated and agreed on a bilateral basis, market prices are not at all available.

- Fixed income trading poses a different problem: data providers such as Bloomberg, Reuters or Markit may offer price data for bond trades, which are, however, derived from internal valuations and in many cases not representative for the execution conditions of specific market participants. In addition, these valuation prices can considerably vary depending on the internally applied valuation model and the data provider from which the prices are obtained. They are therefore largely meaningless and unsuitable as reference values for calculating transaction costs.

- According to the current fallback solution in the absence of intraday prices, transaction costs are to be calculated by using the opening prices of the trading day or the closing prices of the previous day (cf. annex VI para. 14 of the PRIIPs RTS). This leads to the problematic influence of price movements on the calculation results as explained above. The more illiquid a financial instrument is, the greater the distortions in the calculations. These distortions cannot be eliminated under the applicable PRIIPs standards; they are intrinsically embedded in the methodology for illiquid financial instruments. Moreover, the current PRIIPs rules do not provide any solution for the problem of inconclusive price data e.g. in case of bonds.

- Recourse to calculation on the basis of average spreads observed in certain asset classes would largely eliminate distortions due to price movements and consequently, render the calculation results for less liquid financial instruments compliant with MiFID II and IDD requirements. Calculation relying on average observed spreads is already recognised as a standard under PRIIPs for newly launched funds (cf. annex VI para. 21 c) of the PRIIPs RTS). In practice, the relevance of this "estimation methodology" is by far greater, since it is used by many fund providers for calculating transaction costs under MiFID II. The procedure for determining the average spreads can vary and ranges from estimations based on the identified reference indexes to average spreads from proprietary trades and standardised spread tables.

- Reliance on average spreads means that transaction costs under the estimation methodology are significantly less susceptible to fluctuations than the results of the "arrival price" calculations. By applying the estimation methodology firms could largely avoid conspicuous deviations between the transaction costs forecast in the PRIIPs KID and the ex-post cost reporting on transaction costs according to MiFID II. Confusion and dissatisfaction among investors and distributors should decrease.

3. Redefine the calculation approach for transactions in real assets

Calculation of transaction costs for real assets, such as the purchase and sale of real estate, should be based solely on actual identifiable costs.

Reasons:

- Calculation of transaction costs for real assets in accordance with the "arrival price" methodology makes no sense. The "previous independent valuation price", which is to be used as the arrival price for real estate transactions and thus as the reference value for the calculation (cf. annex VI para. 19 of the PRIIPs RTS), has no relevance for determining transaction costs, since the actual acquisition or disposal price does not include any implicit cost elements.

- The acquisition costs of real assets are known in detail and already disclosed in the annual fund reports. They encompass in particular notary and brokerage fees, land registry costs and taxes for real estate transfer. Thus, costs of transactions in real assets should be calculated by summing up those actual identifiable cost items directly associated with a transaction.