Standard Life

Guide to transaction costs in workplace pensions

Scheme Trustees (Trustees of an occupational pension scheme) and Independent Governance Committees (IGCs) have an obligation to consider and report to members annually on the value for money of their workplace pension scheme. When assessing value for money, they need to look at what the scheme offers overall, including member communications, administration, investment solutions and charges to ensure whether they represent value for money but they must explicitly review costs and charges.

The FCA introduced new Conduct of Business (COBS) Rules in January 2018. These aim to increase transparency around charges in workplace pensions by introducing obligations for Providers (workplace pension scheme providers) to calculate and make available transaction costs. This will help Scheme Trustees and IGCs to carry out their duties by requiring Providers and Fund Managers to provide, on request, information on transaction costs for funds used by Defined Contributions (DC) workplace pension schemes. Calculation of the costs must be done according to a standardised methodology set out by the FCA.

In time the rules will help towards comparisons on a year on year basis and also with similar funds although at present there are no benchmarks with which to compare. It is expected that there will be a transitional period before the calculation and disclosure of transaction costs begins to be fully embedded, and before consistent and reliable costs are available over a longer period of time.

What are Transaction Costs?

The costs incurred as a result of the buying, selling, lending or borrowing of investments are called transaction costs. These costs mainly arise as a result of delivering a fund's target investment return where a passive or active investment approach is used. As an example, a fund may need to buy or sell assets when customers pay money into or take money out of a fund and the buying or selling of assets will incur costs.

Transaction costs arise as a result of participating in a financial market and so are separate from any product level administration charges and any annual management charges (AMC).

The transaction cost for buying or selling an investment includes all costs incurred by a buyer or seller from the point an order to transact is received to the point at which the transaction completes. These costs include all charges, commissions, taxes and other associated payments incurred directly or indirectly. Those costs are ultimately borne by assets of the arrangement or of any investment in which the arrangement is directly or indirectly invested. Of these costs some are easily identifiable as specific costs incurred, but some are less identifiable and may rely on judgement.

Disclosure layers and identifiable and implicit costs

- **Aggregate disclosure:** Transaction cost must be disclosed at the overall aggregated top level of an arrangement. This will include the explicit and implicit transaction costs.
- **Explicit costs disclosure:** A breakdown of the identifiable explicit transaction costs must also be disclosed. Identifiable transaction costs include taxes, explicit fees and charges, and costs in connection with securities lending and borrowing.
- **Implicit costs disclosure**: Implicit costs are not disclosed specifically, but are included within the aggregate disclosure. Implicit transaction cost relates to the difference in price of an asset for which it might be bought or sold or other costs which may require judgement to assess.
- **Discretionary disclosure:** Contextually relevant information will be provided specific to each arrangement, where this is deemed beneficial.

How implicit costs are calculated

Transaction costs for workplace pensions must be calculated according to the methodology set out by the FCA's 'slippage cost' methodology. The FCA approach calculates a difference in the value of an asset and the price paid and includes both explicit and implicit costs.

To capture the implicit costs of buying and selling, slippage compares the price at execution '**execution** price' against a fair value price when the order to transact entered the market '**arrival** price' after allowance is made for the explicit costs which are incurred.

Anti-dilution

In a pooled investment the cost of trading in its underlying assets are shared across all its investors. The aim is that transaction cost incurred for day-to-day fund management activity is borne by investors in the fund, but that cost incurred specifically as a result of customers joining or leaving a fund is borne by those investors. In order to achieve fairness for these costs, funds will operate an 'anti-dilution' mechanism to align costs incurred as closely as possible to the relevant customer groups. There are 2 mechanisms which are commonly used to apply anti-dilution mechanism, which can either be by an explicit anti-dilution levy or by using a swinging single price. The value of any anti-dilution activity would be subtracted from the aggregate transaction cost value.

- **Anti-dilution levy** can be imposed on investors as they join or leave a single priced fund and would be applied as an additional charge on buying or selling units specifically targeted at clients transacting on the fund
- **Swinging single pricing** is where a firm calculates a 'mid' price as well as a 'buying' (offer) or 'selling' (bid) price each day. All transactions by customers in the fund (buys and sells) take place at the same price each day and the fund will determine the appropriate price to be used based on whether customers are buying or selling each day. This approach usually uses current transactions but also considers a longer term transaction trend to set the price level (bid or offer) on both a long term and short term perspective which will in the fund manager's view achieve broad fairness for investors.

Workplace transaction cost disclosure vs PRIIPS disclosure

Both disclosures are determined using a slippage cost methodology but with some differences. In the main, workplace transaction cost disclosure is retrospective and so will always look back at costs already incurred while PRIIPS disclosure is prospective (forward-looking) and so will provide disclosures on the basis of both forecast and actual costs (ex-ante and ex-post).

	PRIIPS	Workplace Pensions
Period	Average of last 3 years' costs	Not clearly defined but reporting value for money assessments looks back at the scheme year
Method	Slippage cost	Slippage cost
Anti-dilution	Not allowed for in disclosure	Allowed for in disclosure
Alternative approaches	Involves estimated turnover	None
Arrival price alternative if not available	Opening price if not then last closing price	Last available if not then last closing
Arrival price - Property	Previous valuation used	n/a - explicit costs only
Lending and borrowing costs	Excluded	Included

Glossary

Aggregated value: Costs need only be disclosed at the overall aggregated top level of an arrangement fund without a need to look through to any component funds

Anti-dilution: Mechanisms to protect existing investors from the cost incurred of those leaving or entering the fund

Arrival price: The price against which the mid-market price at the earlier of the time the order was executed or was transmitted to another person for execution. If that is not available this is the last available mid-price on day of execution but if that is not available, it is the previous day's closing mid-price.

Broker commissions: Fees paid to brokers for executing trades

Custodian: The financial institution responsible for safeguarding client assets in pooled funds keeping them separate from those of the fund manager. Custody fees are paid for this service. This does not apply in Insured funds where the assets are owned by the insurer and the policies issued link to the value of the assets. An insured fund may invest in a pooled fund within which custody charges may apply.

Derivatives: Contracts (e.g. future or option) between parties whose value is derived from and is dependent on underlying assets or variable such as a commodity, currency, or security.

Execution price: The price at which the order was executed including all charges, commissions and other payments.

Explicit transaction costs: Quantifiable elements such as fees and taxes that involve payments to another party.

Fair value price: This is the value used for the arrival price under the COBS slippage methodology. For a single-priced vehicle, it is the value before any dilution adjustment and for a dual priced vehicle it is mid-price of the pricing point when the transaction took place.

Implicit transaction costs: the costs of trading that relate to the difference in price of an asset for which it might be bought or sold. There is no payment from one party to another but the estimated loss of value in trading is calculated according to the slippage methodology.

Insured fund: An investment structure where the investors invest in a policy of insurance with the underlying assets owned by the life insurer which has matching liabilities to the policy holders.

Net asset value (NAV): The value of a fund's assets net any liabilities at a point in time

Mutual fund: An investment vehicle that offers pooled unitised investment in assets such as stocks and bonds.

Portfolio turnover: A measure showing the turnover of holdings in a period. A higher rate may indicate that transaction costs will be higher.

Providers: Providers of workplace pension schemes

Scheme trustees: Trustees of an occupational pension scheme

Stamp duty: The transaction tax on the purchase of UK equities