

Know your market



TSSAG board members Barnaby Nelson, Viraj Kulkarni, Matthieu Herbeau, and Jim Harris discuss grey costs, the impact of clients on initial market entry, and the changes expected in the near future

The ValueExchange recently conducted a survey on grey costs, what were the initial drivers for the survey and what did the findings show with respect to the current state of awareness of issues?

Barnaby Nelson: Grey costs per trade are a fascinating topic. We've seen huge amounts of attention on the cost of a trade from a regulatory perspective over the last decade — especially in the context of the Markets in Financial

Instruments Directive (MiFID). In parallel, we've also faced huge internal cost cutting pressures that have been relentless over the same time frame. This has meant that no stone has been left unturned while people have been looking to become as efficient as possible.

When we ran our grey costs per trade industry research last summer, one of the things that really stood out was how little progress we seem to have made in addressing the proper cost of a trade.

Although trade execution is improving and we're getting better at managing our most visible costs, our study shows 50 per cent of the industry is still overlooking about 46 per cent of their costs per trade. If you imagine trading costs to be like an iceberg, the majority under the water is still escaping our attention.

That's not to say that people don't view the space as important. The results found that 71 per cent of the market see their cost per trade tracking as being very important, especially on the intermediary side. Banks and brokers increasingly see their costs per trade as a competitive differentiator, not just in the sense of 'what did it cost me to do my last trade?' but to be able to model out what their best next trade is going to be in terms of liquidity, method of execution, place of settlement and so on.

Unfortunately, there is a constant gap between intent and delivery. The survey revealed 30 per cent of us aren't even tracking a cost per trade at all today and, interestingly, the chief operating officers (COOs) that we spoke to are the ones who are least interested in tracking a cost per trade. This is because they view aggregated costs and are not often paid to worry about unitised costs.

But what does that mean we're missing? First of all, it costs more to clear and settle a trade than it does to execute it. We've certainly gotten to a point where the costs of the trade really aren't in the visible execution. They're not in the front office or the middle office, even. The majority of costs today reside in the back office, most notably in the costs of risk and the cost of capital, which are the first and second biggest areas that we're overlooking.

However, allocated costs are a huge bucket of costs that are causing a major distortion today. These can include anything from the legal expenses triggered by entering a specific market — such as India or Brazil — to the regulatory reporting in each individual market. There are many areas that different departments are managing with a firm and that they are failing to track on a unitised basis. I'm sure many of us have been in the same position where these allocated costs just materialise as an opaque lump sum during budgeting season, passed on from a stranger in another department — with little information around how to control or optimise the costs.

Equally, foreign exchange (FX) costs are a problem. Are we able to say that we're really doing a fantastic job in terms of optimising our FX cost? It's safe to say that's also a major area of challenge across the industry in terms of whether we're delivering best execution for our investor clients.

We are trying our best, but we are missing a lot of back-office costs that really do need more attention.

What's your perspective on grey costs from India?

Viraj Kulkarni: India is one of the few markets which evolves frequently; every time a market evolves, it changes the cost dynamics for investors.

Costs can be split into two parts: regulatory and business. The regulatory costs have a tendency to go up every time there are regulatory changes.

In a regulated market like India, the regulator's thought processes are 'how can we de-risk the market further and how can we make it more compliant?' — which is why the compliance and risk costs keep getting higher.

The above notwithstanding, regulators to an extent treat capital markets as business units. They consider increasing fees, sometimes linking it to the asset size. Every time there is an increase in volume, the businesses bear more regulatory costs. Besides this, the entry costs are another area in markets like India, Brazil. Entry costs do not only relate to regulatory costs, but also the non-regulatory in-country and overseas jurisdiction costs.

The other aspect relates to tax cost. Tax registration is required for filing and return. These costs have a tendency to go up when there is an increase in reporting requirements. More frequent reporting leads to more costs. Further different trading platforms of products lead to additional costs.

A very prominent hidden cost is the reporting cost which is incurred on account of either regulatory requirements or client management information systems requirements. Invariably, over time the number of reports increases significantly.

One of the hidden costs is FX. As India is not an open market, settlements have to be rupee-denominated resulting in FX costs being higher than what you see in a free economy.

Finally, the multiplicity of an ecosystem such as the exchanges, clearinghouses, banks, depositories, all add to grey costs.

It is important to know if CEOs and COOs are looking at cost. If so, while costs can be estimated at the trade level, by the time it is done, a diversity of internal and external factors change it.

This is a continuous process in an evolving markets like India because while the risk keeps assuming new dimensions, the changes become more frequent. It's hard to put down what would be the grey cost, at a finite level.

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With regards to the grey costs at a market entry level, there are two essential elements, documentation and the ongoing operational maintenance charges

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Jim Harris, co-founder and managing partner of Soterium

How does foreign exchange add to this debate?

Matthieu Herbeau: FX costs tend to be in the execution and the performance of the execution rather than the back-office and the settlement costs.

If the FX is managed in-house, the cost layers span from salaries for the traders to operations, IT, office space, and of course, the outcome of the execution, and the performance of the share class and portfolio hedging programme.

Managing the FX in-house does not guarantee that you will achieve a better outcome than through an external provider. This is because FX is not the investors or asset managers core business or area of expertise. Also, because of the access to liquidity, the firm size can keep the investors and asset managers away from the best prices and opportunities.

A second model is the outsourcing of execution and hedging, typically through the custodian or delegated to a specialist firm like an FX agent or an outsourced dealing desk. The custodian model can be more expensive, but comes with the comfort of operational efficiency, favourable credit terms in general and better liability cover.

The question then is how to quantify those benefits on one hand, versus the costs or the price premium that is paid to the custodian on the other hand,

and how is best execution monitored. There is also an oversight issue that is of prime importance, notably under the senior manager regime in the UK: if an execution service is outsourced, you must be able to demonstrate that you master the process and monitor the costs. Custody FX was tarnished by scandals 10 to 12 years ago, but things have improved, even though some legacy hedging programmes will definitely benefit from a bit of attention and some dusting off — this is where transaction cost analysis (TCA) becomes crucial, if not imperative.

The FX can also be outsourced to a specialist FX execution firm that can cover both execution and hedging, at competitive rates vetted by TCA. But you then lose the intrinsic benefits of the custodial umbrella mentioned above. It will require credit lines with multiple counterparties and generates settlement costs that do not exist when dealing with the custodian over the accounts, with no cash wires.

So fundamentally, every firm which is uncomfortable about FX costs should do an assessment of its current process, the volumes they trade, the currency coverage, short, medium, long term objectives, estimate the costs, and then test the market to determine what is the ideal model for the size and activity of the firm. It could also end up being a hybrid model across the various solutions that were mentioned above and this is where, as a firm, we bring value, thanks to our deep understanding of the institutional investors needs

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Barnaby Nelson, CEO of The ValueExchange



in the FX space, and also the extensive knowledge of what solutions are available in the market.

What are your thoughts on the impact of clients on initial market entry?

Jim Harris: With regards to the grey costs at a market entry level, there are two essential elements, documentation and the ongoing operational maintenance charges.

Looking at any global custody network, roughly two-thirds are foreign institutional investor (FI) markets where the beneficial owners' name appears in the market as the ultimate owner of that account. To establish those accounts, investors have to go through differing market entry requirements, some are simple, it's a swift message, but most are not.

Each requires local compliance with market legislation, through powers of attorney, account opening forms, most of which require consularisation, legalisation and if you've ever sat in a consulate waiting for your documentation to be signed, it's not only laborious, but costly because someone's time has been taken. Therefore, whether it be an external consularisation or legalisation, all of those costs come back to the beneficial owner.

In addition, once your documentation is complete, you then need to get it to market.

Courier costs are also coming back to you as a beneficial owner which is charged as 'out of pocket' (Oops) expenses. While reporting on Oops has started to improve, these charges are not allocated back to the individual market, or at the end of the day, the trade itself.

So the reality is that you're not seeing the full picture for the actual market documentation.

The second part is in operational maintenance and the ongoing impact of costs. The appointment of local tax consultants is often seen as separate from your custodian in some instances and it's important to understand where these are appointed, how long for and the remuneration involved.

As well as this, charges from regulators and market participants will also be funnelled back through the Oops process and not directly attributable to the market where the trading is taking place or the trade itself. It's only natural that investment managers will want to take advantage of new markets, but an awareness of how much is invested versus the true costs in the market is important. It's vital that all costs are allocated to the market or the trade.

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A combination of initiatives by industry, the regulator or even organisations, like TSSAG can continuously engage and bring down the grey costs

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Viraj Kulkarni, founder and CEO, Pivot Management Consulting

Simply signing off Oops costs each month is not good enough. All costs need to be transparent, understood and agreed upon not only at the client level, but also for a trustee/administrator level at a pension fund in order to provide a complete picture.

What changes do you expect to see in the near future and what's required to make those changes happen?

Nelson: What's very clear from this discussion is that there are many hidden levels to the cost of a trade: starting at market entry, the trade processing, the FX, the out of pocket expenses, tax reclaims and so on.

These are largely what makes up the 46 per cent that we are overlooking today — but what is key is that we're not escaping these costs, we're just not tracking them. The people that have the best handle on this issue are those who treat their costs per trade as a discipline and as a senior management priority. Those who succeed are making a conscious effort to compile a single, holistic view of their costs across the whole business (from the top of the house) — and they are treating this as an evolutionary journey. It sounds easy, but it's surprising how many organisations are happy to skip over this and just deal with the costs that they

receive on an invoice every month and hence only to deal with the tip of the iceberg.

The other major mistake that some of us are making is assuming that most of our costs are somehow fixed or uncontrollable. If you look at the number of technological and market options that are now coming into the market, we now have more ability to control our costs than ever before.

In FX, we have peer to peer execution; in other areas, you've got blockchain and other technologies that are coming to the market. Proximity is one of my favourite examples of how technology is reshaping our industry and making a radical change in the risk profile and the cost profile of what we do.

This is why I come back to the point about it being a constant discipline. It's not just the cost of moving up and down, it's that the answers and the solutions to those costs are changing constantly. For me, it's a constant re-evaluation to make sure that innovation is being applied to the costs that we've been overlooking for the last 10 to 15 years because we've been focused on the tip of the iceberg.

Kulkarni: We have previously conducted an exercise to determine the lines of costs. These were not merely looking at regulatory costs, custodian cost, banking costs, broking cost. It included the inflow jurisdiction costs, tax costs etc.



Performance reporting tools are key to ensure that hedged share classes perform as well as the master class of the fund



Matthieu Herbeau, CEO and founder of HD Financial Consulting

The overseas jurisdiction costs vary- depending on whether a treaty country/ non-treaty country; Financial Action Task Force (FATF) compliant/non-FATF compliant; subsidy in the overseas jurisdiction. We were surprised that there were over 70 lines of costs both direct and indirect.

The reason we did this study was to look at the attractiveness of this market versus other markets. One of the key objectives of regulators is to determine and assess regularly whether they are doing enough or do we need to do more?

Post COVID many countries including India, are focused on making markets attractive and risk free, as new investors are entering the market. For example, Singapore introduced a variable capital company (VCC) which enables any investor housed in Singapore, to reduce costs by availing government subsidies. Now, this has a bearing on investment flows into the market versus the other markets.

When we did the study, we looked at what can be changed or made better. The Securities Services Advisory Group (TSSAG) is present in over 10 countries, and can get into an engagement with various regulators and bring out a comparative report on the cost of doing business by working alongside various partners that assist regulatory bodies. I find that addressing this big gap will be appreciated by regulators.

Besides instituting the above exercise, regulators can consider charging a fixed cost on assets and do away with the percentage basis. This will significantly reduce the cost to the funds.

Next is to standardise practices across multiple segments and industrialise reporting standards regardless of different systems. This will have a significant reduction in cost.

Outsourcing is an important cost. Custodian activities are presently not outsourced due to limitations by the Securities and Exchange Board of India. Ironically, the whole world outsources its securities services business processing into India but in India, we do not. Outsourcing could save significant grey costs.

Most providers addressing multiple segments will benefit from greater straight-through processing (STP) if the messaging system like SWIFT brings congruency and STP across various segments of domestic and international and thereby reduces costs.

From a business perspective, it is important to seek out the spiralling hidden/ grey cost in the form of increased numbers of MIS sought by clients. These should be controlled by engaging with clients. If not done then silently the number of reports can go into 10s/100s leading to unproductive costs.

So primarily these are six or seven areas, where care, if adopted, can help to bring down the significant cost.

Finally, a combination of initiatives by industry, the regulator or even organisations, like TSSAG can continuously engage and bring down the grey costs.

Herbeau: If the process, the costs and the efficiencies have been identified, then the idea is to move to the solution implementation. Once the decision has been made to carry on managing the FX in-house, or delegate the execution and hedging, the focus will really be on measuring the performance of those two aspects.

We live through interesting times where we see so many interesting developments and innovative solutions in the FX space for institutional investors.

Each cost area seems to have its solution available in the market at the moment.

The attention drawn on costs first prompted the arrival of TCA firms and their product now extends way beyond the post-trade analysis, thanks to the amount of data that is available for FX and the recent technological developments like distributed ledger technology (DLT) will probably pave the way for real time FX TCA.

When you look at spot FX execution for institutional investors, to cover their daily currency requirements to fund the purchases and sales of assets, subscriptions and redemptions in funds, or manage their hedging programme rebalancing, too many firms still execute at the famous WM Company and Reuters (WMR) 4pm fix.

We all heard about the fact that it was manipulated in the past, so the calculation methodology was changed.

But now we have got high frequency traders who have stepped in and exacerbate the trend to make a profit which ends up being detrimental to the investors who should consider using an alternative fixing and we've seen the development of something like Siren benchmark, which is a Financial Conduct Authority authorised and regulated benchmark, which on average generates savings of \$500 per million, which is significant when executing on the same side of the fix against WMR.

Also, investors can look at new liquidity venues such as peer to peer trading, allowing them to meet that at mid rates and negate the market impact as the trades are executed off market.

Firms like Siege FX for spot trading, FX Hedgepool for monthly rollovers of hedging programmes have been live for around a year and receiving more and more interest from large asset managers and corporates too for the former. The savings can be meaningful, both from more competitive rates without spread.

Finally, in the FX hedging space we are also seeing new participants who have developed platforms to secure the process.

Hedging programmes are articulated around the data gathering and processing to calculate the exposure and the adjustment on one hand and the FX execution on the other.

Once this is done, there is a growing regulatory pressure to demonstrate oversight and understanding. Performance reporting tools are key to ensure that hedged share classes perform as well as the master class of the fund.

Custodians are increasingly working on this and so are specialist firms like Lumint. Lumint published a study back in December with New Change FX showing that there is still a long way to go to align the performance across share classes, and waive the grey costs.

At HD Financial Consulting, we have strong ties with the leading providers out there allowing investors to better monitor and manage their costs.

Harris: If I had three words for clients, it would be, 'know your markets', not just at the entry point, but also throughout the life cycle. Know your market and understand that some of these are not just entry of market entry, they are maintenance charges.

Every year they include charges to actually invest in the market and then to service the assets once you are invested.

For example, with environmental, social, and governance (ESG) playing a larger role the importance of proxy voting cannot be underestimated. If I use Brazil, you require a new power of attorney every year, which has to be physically signed, translated and delivered down to Brazil.

Delays in timely tax payments may create cash flow and opportunity costs, which in turn may lead to issues with FX.

Each of these can add up but are ongoing maintenance costs, which if not allocated properly slew the true costs in each market.