

Total cost of ownership in investment services

Discussion paper



The Netherlands Authority for the Financial Markets

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. The AFM promotes the conscientious provision of financial services to consumers and supervises the honest and efficient operation of the capital markets. Our aim is to improve consumers' and the business sector's confidence in the financial markets, both in the Netherlands and abroad. In performing this task the AFM contributes to the prosperity and economic reputation of the Netherlands.

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1 Introduction

In the period from January 2012 until November 2012, the AFM conducted a research into the costs of investment services. One of the findings of this research is that it is difficult for consumers to obtain insight into the total costs of investment services and to compare the costs of various services with each other. The AFM considers the lack of insight into the total costs problematic, because costs can have a major effect on the return and are therefore important for every consumer. The recommendations that emerge from the AFM's research are published in the report 'Research into the costs of investment services'. The specific recommendations in this report can assist investment firms¹ in taking steps towards the provision of clear and simple insight into the costs of investment services, but in order to actually achieve this insight, the mere act of following these recommendations is not sufficient. The most important reason for this is that there is a lack of clear and simple insight into the total costs (both the direct costs that the consumer pays to investment firm and the indirect costs that result from investing in specific financial products such as mutual funds), which means the consumer cannot easily evaluate the services, and cannot easily make a proper price/quality comparison between investment firms and service concepts. The AFM therefore proposes, in line with the recommendations in the report, that the investment firms should present these costs by means of a total cost of ownership (TCO) model as a solution for this lack of insight into the total costs of investing. In this discussion paper, the AFM explains what it has in mind and it invites the market to think cooperatively in more detail about this issue, to start discussions about this issue and to assist in further outlining the TCO.

While the AFM research has focused on investment firms, the AFM is of the opinion that the introduction of a TCO should not be limited to this group of financial enterprises. The AFM considers it desirable that the TCO will be introduced for all forms of capital accumulation with an investment component. This discussion paper therefore is not only addressed to investment firms, but also to firms that offer mutual funds, other types of investment products or capital accumulation products with an investment component.

The AFM would like to give you the opportunity to make known your suggestions, ideas or objections regarding the TCO. The AFM therefore invites you to send your response 18 January 2013 at the latest. You can send your response to discussedocument.tco@afm.nl.

2 Total cost of ownership (TCO)

This discussion paper successively explains: what the term TCO stands for, why the TCO is a solution for the lack of insight for consumers into the total costs of investment services, what is necessary to enable the TCO to be introduced, and how the TCO could be designed.

2.1 Total cost of ownership – what is this?

Total cost of ownership (TCO) is a cost criterion that makes the amount of all the costs of the investment services clear for the consumer. With respect to investing, not only the costs paid by the client directly to the investment firm (direct costs) are relevant. The costs that a consumer pays when investing in a particular investment product, such as a mutual fund (the indirect costs) also ultimately determine the net return of the investment portfolio. A TCO therefore contains both the direct costs and the indirect costs. A TCO is thus not the same as an all-in price, because an all-in price only reflects the direct costs. The inset below provides an illustrative example of such a TCO.

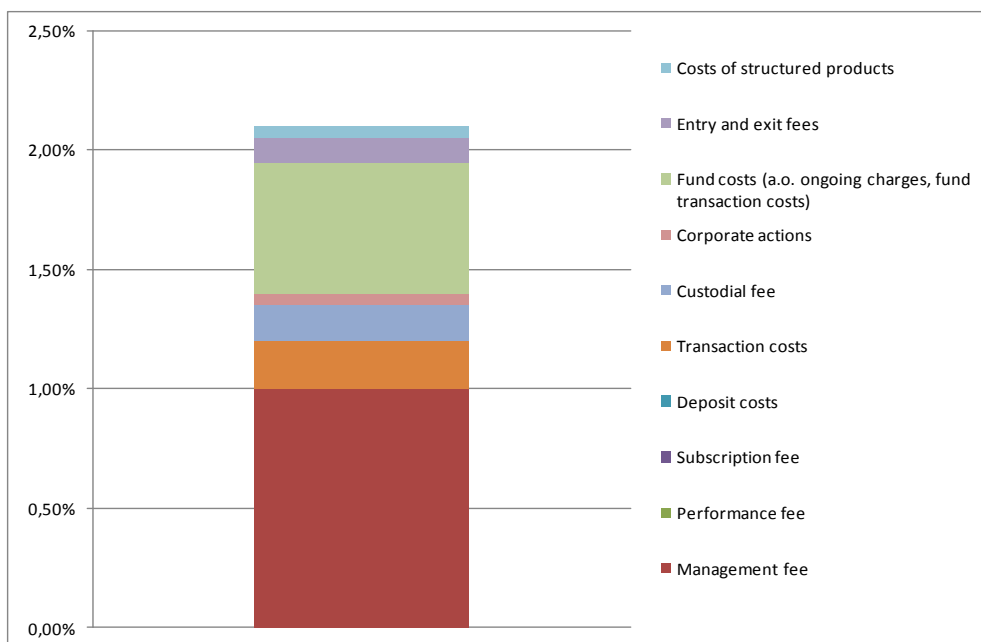
¹ Investment firm in this context include financial enterprises that provide investment services, such as banks and investment firms that provide execution only services, investment advice, and/or asset management to private clients, financial service providers that provide investment services under the Wft Exemption Regulation ('nationaal regime') and investment firms that act as custodians for private clients.

Figure 1: Example of amount and composition of total cost of ownership

Total cost of ownership - Example

The example is illustrative and was drawn up on the basis of average invested capital of € 100,000 invested in individual securities, mutual funds, and structured products.

Cost type	Amount in €	% invested capital
Management fee	€ 1,000	1.00%
Performance fee	€ 0	0.00%
Subscription fee	€ 0	0.00%
Deposit costs	€ 0	0.00%
Transaction costs	€ 200	0.20%
Custodial fee	€ 150	0.15%
Corporate actions	€ 50	0.05%
Total costs charged by the investment firm (including costs charged by custodian)	€ 1,400	1.40%
Fund costs (a.o. ongoing charges, fund transaction costs)	€ 550	0.55%
Entry and exit fees	€ 100	0.10%
Costs of structured products	€ 50	0.05%
Total costs charged by providers of investment products	€ 700	0.70%
Total cost of ownership	€ 2,100	2.10%



The term 'TCO' has existed for decades and is widely applied in various sectors, such as the IT industry. TCO is used in that context to make an estimate of the direct and indirect costs of a product or system². The term TCO has also already been introduced in the financial sector, and more specifically in the funds industry: 'The total cost of ownership can be calculated by adding all the costs of an ETF, both internal and external, and subtracting all the revenues generated over the same time period.'³

² www.gartner.com, visited on 28 September 2012.

³ iShares, *ETP Due Diligence. A framework to help investors select the right European exchange Traded product (ETPs)*, visited on 28 September 2012.

2.2 Why use the total cost of ownership as a solution?

Costs have a significant effect on the return that the consumer realises with investing. Return means the so-called net return, or: the return after deduction of the costs. As previously explained, these costs include both the direct and indirect costs.

Transparency about the costs prior to the provision of service means that consumers are clearly informed about which costs will be directly or indirectly charged to them. This places demands on the completeness and clarity of the information about the costs. It is also important that consumers receive insight into what the total costs of investing will be for them. This goes a step further than transparency. Not only must consumers know which cost items they must take into account, but also consumers must be able to form a picture of what they pay below the bottom line for investing. To do this, consumers are – at the present time - often still obliged to combine percentages, graduated scales and composite prices with their expected trading behaviour in order to arrive at a total amount in euros. The availability of an 'expected TCO' provides consumers with an estimate of the amount of the costs that they can expect over a specific period, for example, a year. If investment firms were to publish the expected TCO for various service concepts prior to the provision of services, it would be easy for consumers to obtain insight into the expected amount of the costs and include this in their selection of a specific service concept. The investment firm, on the other hand, also benefits from insight into the total costs. Insight into the total costs assists the investment firm specifically in its assessment of whether the costs for the target group and the costs for a specific consumer are in proportion to the expected return and the risk of investing.

In addition to the provision of cost transparency *prior* to the provision of services, the AFM considers it important that the consumer has insight into the total costs *during* the provision of services. A 'realised TCO' that is calculated during the provision of services provides the consumer with insight into the amount of the actual costs for these services over a specific period, and into the amount of any costs of the investment products in which investments are made. Both prior to and during the provision of services, the consumer can use the TCO to compare the costs of various service concepts and investment firms easily with each other.

In its research into the costs of investment services, using the price structure for each service concept and assumptions about the trading behaviour, the AFM calculated the total costs of the services each year in euros and as a percentage of the average invested capital. The AFM calculated the indirect costs by making assumptions about the average costs of investment products and the weight of such products in the investment portfolio. The AFM used this method to calculate a TCO based on assumptions for each service concept. The AFM therefore considers it possible that investment firms can calculate the TCO for the service concepts they provide.

2.3 How could the TCO be designed?

Prior to provision of the services

The expected TCO is an estimate of the total costs to be incurred by the client during a specific period, for example, a year. This TCO is calculated on the basis of the price structure of the investment firm and an estimate for the expected trading behaviour. The expected trading behaviour will include the expected investment transactions and the composition of the consumer's portfolio. There are various possibilities for estimating the expected trading behaviour and showing the costs that result from such behaviour.

- In execution only services, the consumer invests independently and therefore the consumer determines the trading behaviour. The client, in execution only services, could therefore be provided the opportunity to fill in the expected trading behaviour in an application, after which the application would display the TCO on the basis of the trading behaviour filled in by the consumer.
- The expected trading behaviour in investment advice services, for example, can be based on the advice provided by the investment firm for each risk profile or for each market scenario. The investment firm can use historical data over a number of years to determine the average advised trading behaviour.

- The expected trading behaviour in asset management, for example, can be based on the trading behaviour performed by the investment firm for each risk profile or for each market scenario. The investment firm can use historical data over a number of years to determine the average trading behaviour that is performed.

The expected TCO, which is calculated on the basis of this trading behaviour, could be included by the investment firm in the public information, such as the website. The investment firm could also calculate an expected TCO that is more targeted at the potential client, for example, by taking account (partly) of the specific characteristics of the client, such as the invested capital that the client wants to contribute.

The expected TCO is partly based on an estimate of the expected trading behaviour, and is therefore partly based on assumptions concerning, for example, the expected investment transactions and the composition of the consumer's investment portfolio. In practice, the realised investment transactions and investment portfolio can differ from these assumptions, so that the consumer's realised costs may be less or more than the expected costs. In this context, it seems logical that the investment firm can explain to the consumer why the realised costs differ from the expected costs. For its asset management services for example, the investment firm can explain to the client which investment decisions have been made and why the realised costs differ from the expected costs. For its investment advice services for example, the advisor can explain which investment decisions made by the consumer have resulted in a difference between the realised and the expected costs.

Obviously, a service concept must be interesting for a consumer not only from a cost perspective, but the service concept as a whole must be interesting for the consumer. Moreover, issues other than costs are also important for consumers, in order to be able to compare service concepts, such as the quality of the service, risk management, and the return. It is therefore desirable that consumers can perform an overall evaluation – based on the, the public information – as to whether a service concept is interesting for them, and that they can compare service concepts on other subjects as well as the costs.

During provision of the services

A realised TCO provides regular insight into all the costs charged to the consumer over a specific period, for example, a year. Since only the realised costs are included in the calculation of the realised TCO, there is no need to make estimates and assumptions to show a realised TCO. Consumers with execution only services and investment advice services, as opposed to asset management services, currently do not usually receive any regular insight into the total direct costs of the services⁴. This means that, especially for execution only and investment advice services, investment firms should take steps to make the realised total direct costs clear to the client. The realised indirect costs – including for asset management services – are currently not made clear to the client. The inclusion of the indirect costs in the calculation of the TCO requires an effort from investment firms, and requires the providers of investment products to provide full insight into the costs of the investment products.

2.4 What is necessary to enable introduction of the total cost of ownership?

The choice of a TCO as a solution to the lack of insight into the total costs of investing means that, before investment firms can implement the TCO uniformly across the market, financial enterprises and the AFM must jointly take a number of steps.

- The development of a market-wide standardised calculation method for the TCO. Joint agreements concerning the method of calculating the TCO should ensure that investment firms use the same method of calculation. Investment firms themselves would preferably prepare these agreements, so that the investment firms will support the agreements. In addition, agreements could then be drawn up by investment firms on the basis of expertise in the market and with a view to the practical feasibility of these agreements. Of course the AFM strives to achieve a TCO that shows the costs as accurately as possible, but the practical feasibility will be an important criterion as well. A standardised method of calculation is also essential, in order to enable consumers to compare different service

⁴ Information provided to clients in execution only and investment advice services is subject to Section 69 of the Bgfo, and information provided to clients in asset management services is subject to Section 70 of the Bgfo.

concepts and investment firms with each other. Essential aspects for joint agreements concerning the method of calculating the TCO include:

- Agreement about the costs that are included in the TCO. The AFM is a proponent of including all the costs in the TCO. This means that all costs must be made explicit and not solely be incorporated in other information. An example where this is not the case, is the incorporation of transaction costs in the transaction amount without explicitly reporting the transactions costs. Another example is extracting costs from revenues. In a number of cases it can be debatable whether or not certain items are actually to be considered costs) and whether or not these items should be included in the calculation of the TCO. Examples of this are: lost income (such as a low credit interest on cash positions), the bid-offer spread costs, and market impact costs.
- Agreement about the method of calculating the costs in the TCO. The AFM would prefer that the method used to calculate the costs matches – as far as possible – the definitions of costs and calculation methods as described in the recommendations of the Federation of Dutch Pension Funds⁵. This would have the advantage that a market-wide standardised method of calculation can be associated with a current process preventing unnecessary workload. This would also promote the comparability of the costs of various products and services that have the goal of capital accumulation. Finally, it would probably be easier for financial firms if the costs of different products and services they provide are calculated in the same manner. Also agreement should be reached on the process of actualisation of the data used in the calculation.
- The development of insight into the total costs of investment products. To be able to calculate a TCO completely, it is crucial that the costs of investment products, as well, are transparent. The research by the AFM⁶ shows that fund costs can have a major effect on the return for the consumer, especially in the case of service concepts with which all investing is made in funds. The inclusion of fund costs and costs of other investment products in the calculation of the TCO requires efforts by the providers of investment products to make the costs of these products fully clear. The efforts that are currently made are in general insufficient. It also requires efforts by investment firms to include these costs in the TCO. If the investment firm does not receive all the information about the costs from the provider of investment products, then – until the time the investment firm receives all the information – the investment firm can make an estimate of the total product costs, or include the information about the product costs that has actually been provided in the calculation of the TCO. Currently, providers of investment products are already providing information about the costs. Since this information is incomplete, the TCO would currently be partially based on estimates or would be incomplete. However, such a TCO would already actually provide consumers with more insight into the total costs than is now the case.
- Agreement about how the TCO is shown. As stated, the AFM is a proponent of showing at least the amount of the TCO in a single figure. There are several ways to do this however. The amount of the TCO can, for example, be expressed as an absolute figure (in euros) and/or as a percentage of the invested capital of the consumer. Moreover, in addition to the amount of the TCO, the composition of the TCO can also be shown. The TCO is composed of various cost items and these cost items could also be made clear, so that it is clear for the consumer how much the different cost items (such as transaction costs, advisory fees, management fees, fund costs, performance fees, etc.) contribute to the total costs. A choice will need to be made for the level of detail, while keeping in mind that the level of detail does not hinder the insight in the costs for the consumer.
- Agreement about the time at which the TCO is provided. As stated, the AFM is a proponent of communicating the TCO to consumers both prior to and during the provision of the investment services. There will, however, be differences between the method of calculating the expected TCO and the realised TCO as discussed in section 2.3.

⁵ Federation of Dutch Pension Funds, *Recommendation on administrative costs 2011*, 17 January 2012. Federation of Dutch Pension Funds, *Recommendations on administrative costs – Further elaboration on asset management costs*, 20 November 2012.

⁶ See report 'Research into the costs of investment services'.

2.5 What is the next step?

The introduction of an expected and a realised TCO provides consumers with clear and simple insight into the total costs of investing and the possibility of easily comparing the costs of different investment services with each other, but requires the necessary efforts on the part of the financial enterprise. The efforts to be undertaken by financial enterprises include first the development of a market-wide uniform TCO, and secondly the implementation of the publication of the expected and realised TCO in their own services. Furthermore, the objective of the TCO to contain all the costs can only be fully realised if the providers of investment products, such as fund managers, are completely transparent about the costs of their product. Because the market for investment services has an international character, the AFM will also bring this discussion paper to the attention of parties operating in a European context. In addition, the AFM will, in the coming period, continue the dialogue with the market.

The Netherlands Authority for the Financial Markets

T +31 (0)20 797 2000 | F +31 (0)20 797 3800

P.O. Box 11723 | 1001 GS Amsterdam

www.afm.nl

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Amsterdam, November 2012