

BANKER & TRADESMAN

AT THE MARGINS

Transaction Costs For Fixed-Income Securities Remain Stubbornly High

A More Diligent Approach Toward Trading Efficiencies Could Help Support The Bottom Line

By [Robert Segal](#) | Special To Banker & Tradesman | Nov 19, 2017



Banking regulations require that financial institutions implement robust systems to monitor, manage and control risks related to investment activities. The agencies state further that effective management of the risks associated with securities represents an essential component of safe and sound practices. The FDIC, for example, says it is prudent for management to fully understand all relevant market and transaction risks. Accordingly, management has the responsibility to put systems in place to assure that all reasonable efforts are made to obtain the most favorable price for each securities transaction.

The market for fixed income securities has evolved significantly in recent years. However, according to the Financial Industry Regulatory Authority (FINRA), the amount of “pre-trade” pricing information (bids and offers) is still relatively limited as compared to equities and generally not readily accessible by the investing public. While new technology and communications in the fixed-income market have advanced, the market remains decentralized, with much trading still occurring on an over-the-counter basis.

Compared to equities, transaction costs for fixed-income securities remain stubbornly high. Academic studies have shown that transaction costs for even small orders of equities are a few

pennies per share, while commissions for corporate and municipal bonds can be several dollars per \$100 of bond principal value, or 100 times higher or more.

Approximately 10 years ago, the SEC instituted a “post-trade” reporting system that distributes information about bond transactions. Under the program, dealers are required to report, with a 15-minute delay, the price and quantity of every transaction. Corporate bonds were the first sector in the platform, followed by municipals and agencies, and more recently, Treasuries and mortgage securities. This innovation improved transparency by allowing investors to obtain more current information about market values.

In a recent regulatory notice, FINRA reiterated its commitment to best execution as a key investor protection requirement. The agency said in light of the advanced nature of fixed-income markets, brokerage firms need to regularly review their procedures to ensure they are designed to incorporate and reflect best execution principles, as the broker is “under a duty to exercise reasonable care to obtain the most advantageous terms for the customer.”

FINRA requires that brokerage firms establish, maintain and enforce robust supervisory procedures and policies regarding “regular and rigorous reviews” for execution quality. As part of its own regulatory reviews, FINRA conducts statistical analyses, establishing pricing parameters for comparison to other transactions in the same security. In fact, if certain transactions show a meaningful variance, FINRA may deem the firm to be in violation of best execution principles.

It is important to keep in mind that best execution does not always mean the lowest possible price. In its Trust Examination Manual, the FDIC said management should consider other factors when determining the quality of execution, including quality of research provided, speed of execution, and certainty of execution. Regulators also recognize that obtaining quotes from too many sources could adversely affect pricing due to delays in execution and other factors.

Given the regulatory environment and improvements in transaction reporting, bank management may wish to implement a “back-testing” program to assure that the institution is receiving the most favorable prices for securities transactions. This surveillance tool could compare the institution’s pricing to prevailing market prices at the time of the trade, while also analyzing the bid/offer spread to confirm that the transaction “mark-up” was fair and reasonable.

A direct benefit is that the financial institution should see improved profitability as it routes business to brokerage firms that provide the lowest overall transaction costs. Corporate governance can be enhanced as risk management policies and procedures continue to be strengthened.

As the programs evolve, bank treasurers can ultimately establish a system for evaluating broker/dealer performance. The FDIC requires that financial institutions develop and approve an effective vendor management program framework. What the FDIC is looking for, according to industry observers, are well-defined documentation processes. The regulators see vendor risk management as needing continual monitoring and ongoing risk assessments.

Finance officers typically scrutinize the P&L in a finely-tuned manner. At the same time, most bankers acknowledge they don’t know what they’re paying for brokerage costs for securities transactions. Transaction costs can vary greatly based on the scope of the transaction and access to the most liquid dealers. A review of individual transactions indicates that investors may be leaving a lot of money on the table. A more diligent approach toward trading efficiencies could help support the bottom line.

Robert B. Segal is president of Atlantic Capital Strategies Inc., an investment advisor located in Bedford. He can be reached at bob@atlanticcapitalstrategies.com.