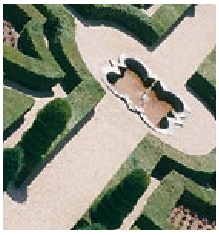
# UNLOCKING THE POTENTIAL OF THE AUTHORISED CONTRACTUAL SCHEME



*The advent of the Authorised Contractual Scheme presents a range of opportunities for UK insurers to meet the challenges of cost pressures, distribution and low yield environment. Northern Trust's Andrew Melville, head of insurance product and strategy and Phillip Caldwell, head of tax-transparent pooling product, explore the key benefits.*

## CHALLENGES FOR UK INSURANCE COMPANIES

As the UK Authorised Contractual Scheme (ACS) passes its first year milestone, demand is starting to gather momentum with several schemes looking to launch across both the insurance and the wider investment community. Before examining the ACS's specific benefits for the insurance sector, we would like to set these in the context of three challenges faced by insurance companies today: cost pressures, distribution and the low yield environment.

### *Cost pressures*

The 2014 EY Global Insurance Outlook reports states that in 2014 successful European insurers 'will need to simplify, restructure and alter their business models… to create more efficient operations'[1]. This could involve re-examining fund structures and eliminating duplications arising from historic merger and acquisition activity.

The UK Authorised Contractual Scheme is a regulated UK domiciled tax-transparent fund. Enacted into UK regulation in July 2013, the ACS aligns the UK investment funds regime with other European jurisdictions offering tax-transparent pooling vehicles. It is exempt from income tax and chargeable gains and enables investors to access their appropriate tax rate. While chiefly triggered by the UCITS IV master feeder fund structure and Solvency II, it can be established as a UCITS, non-UCITS or Qualified Investor Scheme.

### *Distribution challenges*

As pressures mount on profit margins for insurance companies, they are looking to new markets to distribute their products. This would include well established markets as well as the 'New Europe' countries. Furthermore, with the additional obligations arising from new regulatory requirements such as Packaged Retail Investment Products (PRIPS) and the Retail Distribution Review (RDR), these distribution pressures will continue to mount.

### *Low yield environment*

The low yield environment is likely to stay for the foreseeable future, with long term interest rates likely to remain low. This has forced insurers to look at other forms of investment, different asset classes and investment structures.

## BENEFITS OF UK ACS FOR INSURANCE COMPANIES

Each insurance company is different and there are a number of reasons why they would potentially adopt such a structure but we have identified a few specific benefits that in isolation or collectively could be advantageous to the insurance company.

1. 2014 EY Global Insurance Outlook report

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## QUANTITATIVE BENEFITS

### *Fund rationalisation*

In our experience, insurers' investment portfolios often include large numbers of individual funds servicing individual markets and investment strategies. Many of these funds may have evolved sporadically via mergers and acquisitions. Consolidation via an ACS can potentially maximise synergies and cost savings.

For example, if an insurer has five UK equity funds with £100 million in each fund, a typical cost for non-asset management charges including; distribution, administration and custody may be in the region of 40 bps. On that basis, the costs for the five funds would be £2 million (£400k per fund).

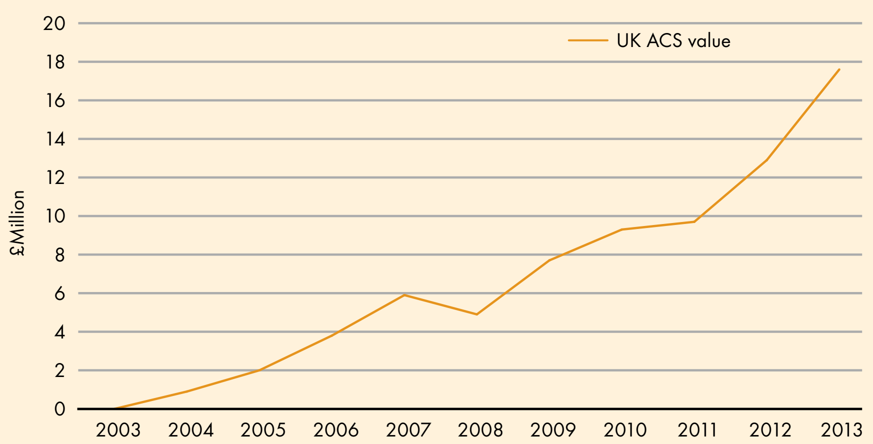
In this example, a saving of up to £1.6m may arise by rationalising into an ACS structure. This could be achieved by consolidating these five funds into a single UK equity fund within that structure. Over different fund ranges and fund number reductions, this saving could be quite substantial.

### *Tax efficiency*

Currently investors in a UK life company are treated in a tax efficient manner therefore historically there have been advantages for using this type of investment vehicle. Under the UK ACS those benefits will remain, however, it is likely that there may be some additional tax savings providing extra return to investors

As an example, the chart below provides a year-on-year illustration of the additional value obtained by a UK pension fund investing in an ACS compared to an investment via a UK life company based on an MSCI Euro Equity Strategy. It shows returns may be enhanced by as much as £17 million on a portfolio of £1 billion invested in broad European indices over a 10-year period if investing via a UK ACS.* The difference is due to the additional benefits available to the UK pension fund under the UK treaty network when investing through a UK ACS as opposed to the UK life insurance company.

**UK ACS VALUE**




**The result is obtained by comparing the net yield achieved by a UK pension fund and a UK life insurance company against the yield for the MSCI Europe Index. The following assumptions are: 1). MSCI Europe yield of 3.45% over the 10 year period 2). The UK pension fund and UK life insurance company as a result of withholding taxes would have a lower yield. 3). UK life insurance companies have carve- outs in certain treaties to allow exemption for pension business.4). No change in the current withholding tax rates over the period. On a yield comparison both the UK pension fund & UK life insurance company would suffer a lower yield due to the withholding tax suffered.*

## QUALITATIVE BENEFITS

### *Greater distribution capability*

As the ACS allows for cross border activity, its use can help insurers become more efficient in replacing multiple funds, typically with a master feeder structure. Rather than using a fund for each market, a single tax-transparent fund vehicle can be established and the components adjusted to suit various regional market requirements without losing the overall benefits of fund rationalisation and tax transparency. In this way the ACS can represent a smarter way for insurers to distribute and deliver investment performance for their policy holders.

### *Credit risk reduction*

The ACS reduces the credit risk inherent in the use of a life policy. In the event of insolvency occurring strict ring-fencing exists in the ACS structure between the sub-funds. For the most part Life Insurance policies are subject to the credit exposure of the underlying provider and any related re-insurance contract undertaken. The ACS can provide both clarity and greater bankruptcy protection.

## AN EXPERIENCED APPROACH TO SUPPORTING TAX-TRANSPARENT FUNDS

Northern Trust is an established leader in the provision of fund administration, custody, legal, tax and product solutions to European tax-transparent funds. We have been providing operating solutions since 2005, when the industry's first tax-transparent asset pooling funds were launched in Luxembourg and Ireland. We currently support the majority of tax-transparent funds in Ireland as well as supporting our clients in other jurisdictions such as Luxembourg and the Netherlands.

Northern Trust is at the centre of industry developments through our consultations with governments and industry bodies to help drive industry innovations, including being instrumental in supporting HM Treasury with the development of the UK ACS. This culminated in hosting the official launch in July 2013 in conjunction with HM Treasury, the IMA, HM Revenue & Customs and the Financial Conduct Authority.

## FOR MORE INFORMATION

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