INVESTIGATOR

HOW UK DB PENSION FUNDS CAN SAVE £2.4 BILLION OVER THE NEXT 10 YEARS

Investigation into the use of less tax-efficient funds by UK private defined benefit schemes

Tax-efficiency has become an important factor for fund performance in recent years – particularly for pension funds that suffer too much withholding tax (WHT) on the dividends of their pooled equity investments. This is because UK pension schemes, as tax-exempt investors, are entitled to reduced WHT on dividends from global equities under double taxation agreements.

However, unless they invest via tax-transparent funds or insurance policies for their pooled fund investments, pension schemes will not be entitled to apply for reclaims or reduced WHT to foreign governments' tax authorities on their foreign equity holdings. As a result, many pension schemes in the UK are potentially suffering more WHT than may be necessary, which may reduce schemes' income and ultimately have a negative effect on company sponsors' ability to meet member payments.

AMX and Northern Trust commissioned research from Broadridge Financial Solutions between January and April 2020 to investigate the potential tax inefficiencies among UK private sector defined benefit (DB) pension schemes. Please refer to our survey overview on page 4 for further information.

KEY FINDINGS

1 **UK private DB pension schemes are unnecessarily paying £256 million in WHT annually.**
This represents 46 basis points of cost per annum on their global equity holdings – an unnecessary cost that could be mitigated through the use of tax-transparent fund structures.

2 **Cumulative tax drag for UK private DB schemes for the 10 years from 2019 will total £2.4 billion.**
This forecast allows for likely changes in the scale of DB assets and changes in allocation to equities.

3 **72% of schemes invest via less tax-efficient fund structures.**
The most highlighted structures mentioned were unit trusts, investment trusts and OEICs.

4 **Large and small schemes use less tax-efficient funds.**
69% of large schemes and 77% of small schemes use less tax-efficient funds.

5 **Awareness of the costs of less tax-efficient investing is low among UK DB schemes.**
69% of respondents from schemes using less tax-efficient funds are unaware of the benefits of tax-transparent funds relative to other fund structures. In addition, 69% had not discussed this topic with advisers and 82% said that the topic of considering tax-efficient fund structures for equity investments was not included in their scheme's risk register.

LESS TAX-EFFICIENT INVESTING REPRESENTS VALUABLE LOST REVENUE

Our findings show private sector DB schemes in the UK unnecessarily suffered more than £250 million in 2019 in withholding tax. Based on these tax inefficiencies, the projected cumulative 'tax drag' for UK DB schemes for the 10 years from 2019 could total £2.4 billion.

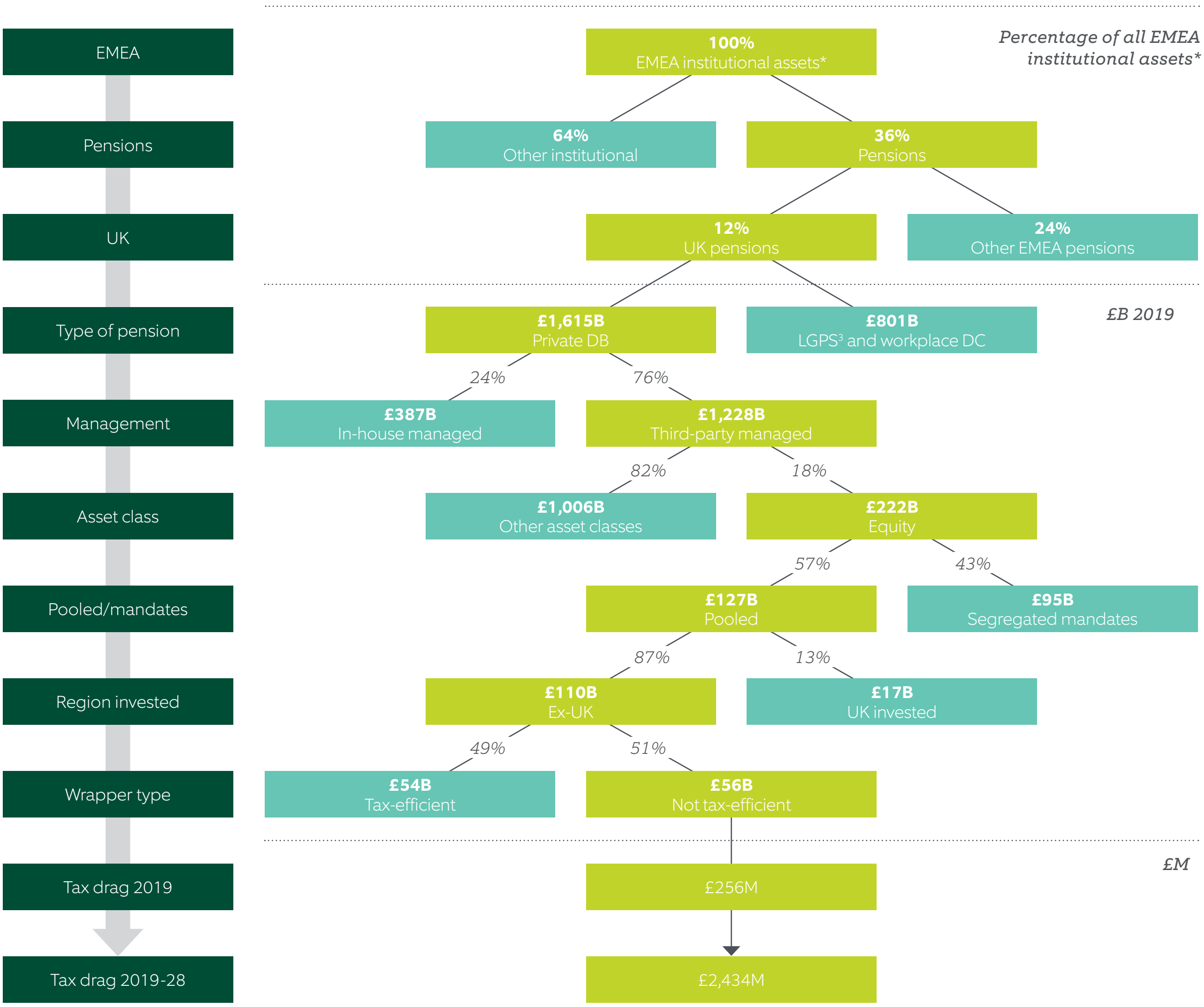
This level of tax drag represents valuable lost revenue for UK DB pension schemes and their members.

These findings carry particular urgency against the backdrop of economic conditions caused by the impact of the global COVID-19 pandemic.[1] At time of writing, this has already seen average pension fund values fall by more than 15% in the first quarter of 2020 – the worst quarterly performance on record.[2]

However, even before the onset of the pandemic, the majority of mature private UK DB schemes were moving into a phase of net cash outflows.

Against the backdrop of a potentially prolonged economic downturn, many schemes collectively face the prospect of widening funding gaps, with some scheme sponsors in potential financial difficulty.

FINDINGS IN SUMMARY FROM INVESTIGATION OF NON TAX-EFFICIENT USE BY UK PRIVATE DB SCHEMES



Source: Broadridge Financial Solutions, multiple sources

*EMEA institutional assets are 72% of total EMEA assets, when including retail/wholesale assets

1. Potential impact of Covid-19 is not included in 10-year forecast
2. *Moneyfacts UK Personal Pension Trends Treasury Report*, reported in FT Adviser, 30 April 2020
3. Local Government Pension Scheme

The solution: Investing via a tax-transparent fund

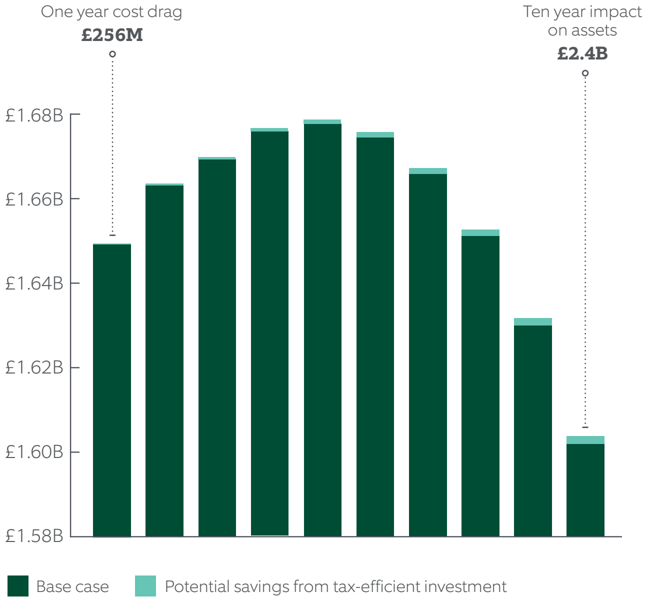
In order for tax-exempt institutional investors to benefit most effectively from the use of pooling, a tax-transparent fund (TTF) structure is generally recommended. Most TTFs are structured so that, for tax purposes, 'look-through' tax treatment is applied, on a per-investor basis.

The fund's underlying investors can then benefit from double taxation treaty agreements on eligible WHT relief as if the securities were held directly. Switching to a TTF does not require changes to the scheme's asset allocation policy or to their selected managers.

Elimination of tax drag facilitates improvements in investment performance – and even small variations in expenses can, over time, make a significant difference to investment returns.

FORECAST OF TOTAL ASSETS OF UK PRIVATE DB SCHEMES 2019-28

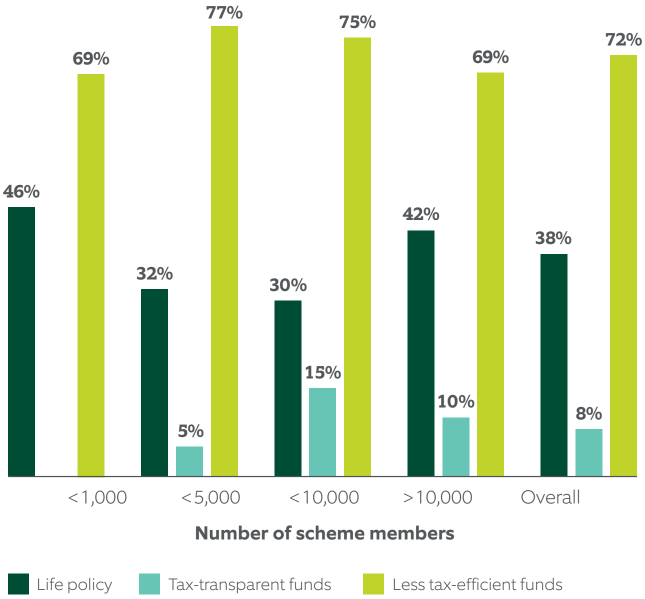
Including forecast impact of cumulative benefit of tax-efficiency opportunity highlighted in this report.



Source: Broadridge Navigator

USAGE OF EQUITY FUND WRAPPERS AMONG UK PRIVATE DB SCHEMES

Percentage of number of schemes/n=107



Source: Broadridge Financial Solutions Survey of 120 DB schemes

CONCLUSION

Significant scope exists for UK private DB pension funds to improve the tax-efficiency of their equity investments. If they have not already done so, now is the time to begin discussions with their advisers and investment managers about where opportunities exist to enhance the tax-efficiency of their investments – and make use of withholding tax reclaims or relief at source to which they are entitled.

Similarly, asset managers that operate, or are planning to launch, listed equity funds should consider how the use of a TTF may be of benefit. Use of a TTF may offer superior investment returns for investors through the potential reduction in withholding tax drag, compared with that incurred by traditional pooling vehicles such as unit trusts or open-ended investment companies (OEICs).

It is now potentially more cost-effective than ever for asset managers to derive the advantages of tax transparency, while optimising and creating efficiencies across their fund ranges.

AMX can help you invest via a more tax-efficient fund structure. We design and build tax-efficient pooled funds while providing additional governance and operational oversight, and Northern Trust, as global custodian and fund administrator, has long-standing expertise in servicing and structuring European tax-transparent vehicles.

Together, we can help institutional investors access the advantages of investing via tax-transparent funds – and for asset managers, we can help you offer your clients tax-transparent funds easily and efficiently.

SURVEY OVERVIEW

This study aimed to estimate the total value of all less tax-efficient funds held by private DB pension schemes. Based on this, we sought to reveal the extent of the withholding tax being unnecessarily paid on these assets over the course of one year (2019) and the cumulative impact over 10 years.

PROCESSES AND METHODOLOGY

In order to reach our conclusions, we:

- Identified the value of all pension assets managed in the UK
- Fine-tuned our analysis to UK private DB schemes
- Stripped out in-house managed assets, as tax inefficiency is found in third-party managed assets
- Narrowed our focus to equity assets, as inefficiency arises in this asset class
- Excluded all segregated mandates to focus only on pooled funds and co-mingled assets
- Focused on ex-UK invested funds, as inefficiency does not arise on UK investments
- Identified the proportion in less tax-efficient vehicles

Having identified the total value of all less tax-efficient funds held by UK private DB pension funds, we calculated the tax drag unnecessarily paid in 2019. We then estimated the cumulative drag for the 10 years from 2019 to 2029.

Telephone research into UK DB pension schemes

We spoke by telephone to 120 UK private DB schemes, ranging in size from £30 billion to £1 million between February and April 2020. The median size of scheme we spoke to was £1.2 billion. At time of survey, there were 5,422 UK private pensions schemes, which between them hold £1,615 billion in assets. UK pension assets are concentrated in larger schemes: 193 DB schemes with more than 10,000 members (4% of the total) hold 62% of the assets. This sample was intentionally weighted towards schemes with larger memberships, where most assets are held, and represents 28% of UK private DB assets.

In forming conclusions from the survey, we weighted the conclusions to allow for the market- wide distribution of assets. Since schemes with more than 10,000 members make up 62% of total DB assets and they represented only 42% of our survey sample, this weighting had the effect of increasing the influence of the responses of the larger schemes.

Annual tax drag calculations

The annual tax drag figure of 46 basis points (bps) is calculated based on the largest five investment markets in the MSCI World index:

- US – the comparison used for the modelling was an Irish ICAV suffering 30% WHT. If this was modelled against a UK OEIC suffering 15% WHT, this would reduce the bp comparison to 26 bps.
- Japan – whilst tax-transparency for UK pension schemes in a UK Authorised Contractual Scheme is recognised in the Japan/UK tax treaty, this has not yet been proven as also applicable to the Irish CCF. This work is in progress and the 0% rate achievable is reflected in the calculation.
- UK – as there is generally no withholding tax applied to entitlements, investments in UK equities are little impacted by the choice of investment vehicle.
- France – tax relief on French entitlements is generally applied at the level of the fund.
- Switzerland.

Expanding this to all of the markets within the MSCI World index where a tax service (look through and fund level) is offered would increase the savings by 3-4 bps. The 46bps tax uplifted, calculated as described, has been applied to the UK Pension Schemes non-UK equity exposure via tax-inefficient pooled vehicles. However it should be acknowledged that different indices/investment market weightings will yield different results, as will the number of tax transparent investment markets being supported e.g. compared to the MSCI World, the MSCI ACWI yields a slightly lower tax uplift of 41 bps.

ABOUT THE ASSET MANAGEMENT EXCHANGE

The Asset Management Exchange (AMX) is an institutional platform that gives investors and asset managers a way to do business with each other. Built with a fund infrastructure that's designed for the needs of institutional investors, AMX standardises, centralises and streamlines the entire process of investing so it works better for everyone.

Established by Willis Towers Watson in 2017, AMX negotiates with managers, transitions assets, provides reporting and adds an extra layer of oversight. The platform is open to all investors and managers across the investment industry.

For more information:

Investors
Jignasa Patel
jignasa.patel@theAMX.com

Managers
Aaron Overy
aaron.overy@theAMX.com

theAMX.com

ABOUT NORTHERN TRUST

A proven partner to pension funds and global investment managers, Northern Trust has more than 30 years of experience administering the full spectrum of investment strategies for clients around the globe. We help facilitate improved speed-to-market, operational efficiency, business focus and distribution for our clients' traditional and alternative funds.

We are pioneers in the use of asset pooling and tax-transparent funds, currently servicing more than £200 billion in tax-transparent funds globally (as of 31 March 2020). We have supported the first tax-transparent cross-border pooling solutions for multinational corporations in 2005 in Luxembourg and Ireland, and contributed to the development of the UK's Authorised Contractual Scheme fund vehicle through participation in HM Treasury working groups.

For more information:

Douglas Gee

Head of Asset Servicing Business Development, Europe, Middle East and Africa
douglas_gee@ntrs.com

northerntrust.com

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