

# Catching the wave: Regulatory change creates new opportunities for tax-transparent cross-border pooling

By Aaron Overy, Northern Trust

**Regulatory changes currently sweeping across Europe are creating a wave of opportunity. From the UCITS IV Directive to Solvency II, the advantages of pooling funds/assets into a single tax-transparent vehicle are being highlighted. For EU Member States, the race is on to encourage fund managers, multinationals and insurers/reinsurers to establish vehicles in their domiciles. As the United Kingdom looks to enter the market, established centres such as Ireland, Luxembourg and the Netherlands are taking steps to boost their competitiveness.**



The development of a UK tax-transparent contractual fund regime is the latest milestone in a new era of opportunities for the European cross-border pooling industry.

Today it is estimated that in excess of US\$80bn in investor assets are utilising tax-transparent cross-border vehicles such as the Irish Common Contractual Fund (CCF), the Luxembourg Fonds Commun de Placement (FCP) and the Dutch Fonds voor Gemene Rekening (FGR). This figure is likely to rise due to a combination of drivers including:

- **Undertakings for Collective Investment in Transferable Securities (UCITS) IV Directive** – the master feeder fund structure will be highly suited to a tax-transparent contractual pooling vehicle as it will permit feeder funds in different domiciles to invest in the same master vehicle, whilst maintaining withholding tax (WHT) outcomes;
- **Solvency II** – for life and pension reinsurers this could bring about a fundamental shift as they potentially move from having policy holders to unit holders, highlighting the need for a tax-transparent structure;
- **US regulations** – US developments such as the Dodd-Frank Act and Foreign Account Tax Compliance Act (FATCA) will potentially impact investment managers with US clients, and highlight the advantages of achieving greater oversight and tax-transparency over assets;
- **fund rationalisation** – in the post-financial crisis environment, the need to more closely manage cost and risk is encouraging multinationals, insurance companies and fund managers to closely examine their legacy funds and consolidate; and
- **focus on achieving a single, pan-European pension platform** – the Activities and Supervision of Institutions for Occupational Retirement Provision (IORPs) Directive provides a framework to centralise investment and scheme administration

arrangements, to provide a single point of pensions excellence.

These drivers are taking place against a broader shift to tax-transparent fund structures as pension funds and other institutional investors experience an increase in the tax benefits available following tax treaty negotiations. A tax-transparent fund is designed to enable the investor to achieve the same WHT benefits as if they had invested directly in the underlying assets.

Grouping pension funds and other assets into a cross-border pooling fund also offers the following broad benefits:

- **economies of scale** – potential for significant cost reductions in many areas including investment management, administration, custody, audit and service fees;
- **enhanced governance and risk management** – a centralised pool of assets enables a streamlined approach to asset monitoring and plan oversight;
- **consistent, global investment strategy** – a centralised decision-making process able to accommodate multiple strategies to support regional variations; and
- **better performance** – access to best-in-class managers and specialised investment mandates.

## UCITS IV: Opportunities and obligations

UCITS IV presents investment managers with substantial opportunities for wider and more cost-effective fund distribution. In particular, the ability to “passport” funds from country to country through a single pan-European management company is a significant development with positive repercussions for pooling.

Under the new framework, a UCITS-authorized management company in one EU Member State will be able to manage a UCITS fund located in another. Therefore, a management company no longer needs

to operate in every jurisdiction where UCITS funds are domiciled. This allows for a single portfolio of assets to be offered for different types of investors based in multiple jurisdictions.

This further builds the case for moving funds across Europe into the centrally managed pooling model, to benefit from a consistent, "best in class" management strategy and operating cost efficiencies.

In the wake of the Directive, EU jurisdictions are looking to capitalise with the UK developing a tax-transparent contractual fund regime.

Investors may also benefit from significant potential tax efficiencies. The use of a master-feeder fund to pool investor assets under UCITS IV can result in the reduction of tax "drag" potentially by as much as 60 basis points,<sup>1</sup> giving institutional investors greater returns on investment.

Other potential benefits available include a simplified and swifter process for entering and distributing in new European markets through the recognised and trusted UCITS brand.

In response to this opportunity, Northern Trust is experiencing interest from investment managers for its fund "hosting" service available through our Irish-domiciled Northern Trust CCF, which provides a platform for investment managers to offer proprietary investment strategies in a tax-transparent cross-border pooling vehicle, which is UCITS compliant. Within the CCF, investment managers can establish sub-funds suitable for large institutional investors with distinct portfolios of assets, investment guidelines and fund features.

UCITS IV's opportunities also come with a wider set of obligations for increased levels of governance and oversight over the day-to-day operations of the fund, its policies and controls. These include a requirement to produce a Key Investor Information Document (KIID), (the document providing investors with an understanding of each fund's risks and rewards) for each fund and/or share class, as well as identifying opportunities for the use of master-feeder funds.

Again the cross-border pooling model is of advantage as it offers enhanced governance and risk management.

## Solvency II

Solvency II is a new solvency framework being developed for all EU insurers (life and non-life) and reinsurers which aims to facilitate the development of a single market in insurance services, whilst securing an adequate level of consumer protection. It aims to provide principles to guide insurers overall risk management to enable them to better anticipate and respond to any adverse events.

Solvency II has parallels with the Basel II banking

regime, with a proposed three pillar structure comprising: (1) quantitative capital requirements, (2) supervisory assessment and (3) market disclosure.

While the specific requirements for Solvency II are still evolving, it is likely to drive a fundamental shift in the way EU insurers approach their asset management model.

It introduces a "total balance sheet" type approach where all risks and interactions are considered. Under proposals being discussed, reinsurers would need to reserve additional regulatory capital for assets such as equities on their balance sheet to provide a greater buffer to withstand market shocks. This could prompt EU life and pension reinsurers to move from a "policy holder" to "unit holder" model as a way of meeting this onerous capital adequacy requirement.

This represents another opportunity for tax-transparent asset pooling. Due to their scale insurance sector funds are usually already operating on a cross-border basis. Whilst undertaking the change to distributing funds where the fund owns the assets rather than the insurance company, and in order to preserve the WHT treatment of their investors, the new fund will have to be tax-transparent.

Suitable existing structures include the Irish CCF or Luxembourg FCP and Dutch FGR. The application (or not) of UK Stamp Duty is also an important consideration.

Other factors driving consideration for the need for tax-transparent pooling structures include the potential counterparty risk in contracting with an insurer; transparency issues over services such as securities lending and distribution of insured products on a cross-border basis.

## US regulatory developments

Further afield, US developments such as the Dodd-Frank Act and FATCA will potentially impact investment managers with US clients, and highlight the advantages of achieving greater oversight and tax transparency over assets.

## Fund rationalisation

The move to tax-transparent cross-border pooling is also being supported by the move to fund rationalisation. In the wake of the global financial crisis, multinationals, insurance companies and fund managers are looking for tighter management over their suite of assets to more closely manage performance and risk, and reduce costs. Many have also inherited legacy funds as a result of mergers and acquisitions and are looking to rationalise their portfolios.

Redomiciliation from offshore to onshore locations is also a consideration as investment managers

consider the impact of UCITS IV in addition to a host of other regulations including the Alternative Investment Fund Managers Directive (AIFMD), the Dodd-Frank Act; FATCA and FIN 48.

If you are changing fund domicile and potentially structure, a tax-transparent pooling structure should be a consideration given investor and asset type.

## Domicile selection

When considering where to domicile the cross-border pooling vehicle, the potential opportunities will vary depending on factors such as the investor's base, geographic profile and the fund strategies.

For the fund manager, tax treatment is a key consideration. With regards to UCITS IV, Ireland and Luxembourg have given assurances they will not create local tax liabilities for foreign UCITS IV funds managed by an Irish or Luxembourg UCITS IV management company.

Under the UCITS IV master-feeder structure, both the Irish CCF and Luxembourg FCP can be the tax-transparent master for feeder funds from around Europe. Tax transparency maintains the WHT treatment of the feeder funds which can participate in

the scale of the master. This helps to resolve cross-border fund distribution problems as you can maintain treatment and infrastructure in the various countries of distribution. The Dutch FGR is also a potential fund in this respect.

## Development of new UK tax-transparent fund regime

Meanwhile, the development of a UK authorised fund regime for a tax-transparent contractual vehicle is set to further enrich the domicile options available in Europe.

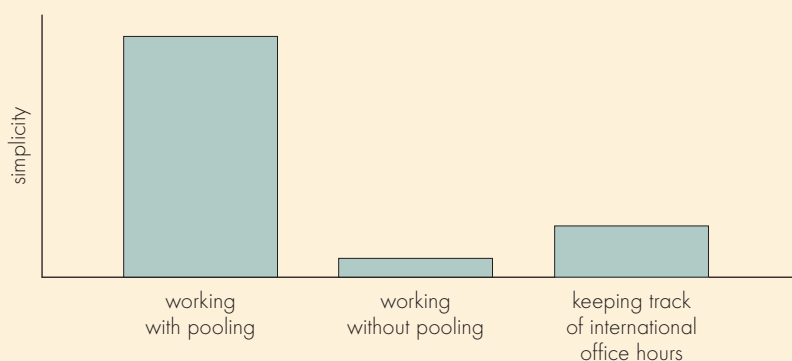
The vehicle, planned for introduction in 2012, will add to vehicles such as the Irish CCF, Luxembourg FCP and the Dutch FGR to provide a tax efficient platform for institutional investors.

Entry into the market has been chiefly spearheaded by the advent of the master-feeder structure being implemented under UCITS IV as well as Sovereign II.

With careful structuring, a UK tax-transparent asset pooling vehicle could become the vehicle of choice for those asset managers that already operate large UK fund ranges. It is also anticipated the vehicle could allow legacy defined benefit assets to be co-invested

## CROSS-BORDER POOLING

and its effect on your daily existence



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alongside new defined contribution plans, to achieve common investment platforms. This is also possible with careful structuring under the Irish CCF, Luxembourg FCP and Dutch FGR models.

Demand is also expected from outside of the UK as an option for European, Asia and US based asset managers who are looking to operate a central platform for their global fund distribution needs.

The technical aspects of the new regime are currently being developed in consultation with industry representatives including the Investment Managers Association (IMA) and Northern Trust which provides custody, fund administration and asset management to vehicles domiciled in Ireland, Luxembourg and the Netherlands.

## IORP Directive developments

Greater acceptance for the benefits of cross-border pooling funds is encouraging multinationals to build on this concept, through the development of a pan-European pension scheme platform. A pan-European pension plan would be domiciled in one EU country with participation by employees across the European Economic Area (EEA). This would potentially provide a single point of pensions' excellence.

Under this model, investment and scheme administration arrangements could be centralised resulting in a range of benefits. These include seamless pension coverage for mobile employees, reduced internal management time, direct cost savings through economies of scale and improved governance and compliance.

## How does this concept fit into the current European pensions' landscape?

The EU Directive (2003/41/EC) on Activities and Supervision of Institutions for Occupational Retirement Provision (IORPs), known as the IORP Directive provides regulatory mechanisms to support the operation of cross-border occupational pension vehicles. The IORP directive was published in 2003 with all Member States in compliance by 2007. However, the cross-border provisions have been relatively slow to take off with industry analysis showing relatively few true cross-border IORPs in operation.

The IORP Directive notably allows pooling of contributions and liabilities into a single cross-border vehicle with defined benefit (DB) and defined contribution (DC) sections. This supports the current trend for the phasing down of DB schemes in favour of DC arrangements.

The competition to be a domicile of choice for these vehicles is increasing as interest in IORPs cross-border potential builds. Under the requirements an

employer, irrespective of its country of registration or operation, can establish an IORP vehicle in any EEA country to cover participants from other countries within the EEA. While the cross-border IORP is authorised and regulated by the country in which the pension fund is established, the benefit schemes must comply with the social and labour laws of various employee-based (host) countries.

As an example, Northern Trust anticipates the use of an Irish Master Trust IORP with DB and DC sections, investing via the tax-transparent Irish CCF. This could operate alongside direct investment in the pooled fund by plans which do not want to use the IORP to pool assets and processes.

Over the past 12 months, we have observed useful examples of multinationals utilising cross border pension IORPs via the Belgian Organisation for Financing Pensions (OFF), including:

- a multinational that uses a Belgian OFF to manage its surpluses and deficits, solidarity being used to net them off. It also uses a corporate compartment, which allows a contingent asset to offset deficit (but which is not a trapped surplus);
- US-based multinational that benefitted from €75m of DB financing savings by moving to a Belgian OFF; and
- US multinational with Greek employees concerned about exposure to Greek bonds via DC arrangements with a Greek insurer; moving those employees to a Belgian OFF.

The comprehensive *Feasibility Study for Creating an EU Pension Fund for Researchers* published in June 2010 by Hewitt Associates is informing current debate about the use of cross-border IORPs. Prepared for the European Commission Research Directorate-General, it explores the legal, technical and financial terms and requirements that should be considered for setting up a viable pan-European framework of occupational pension arrangements that could best match EU researchers' needs.

As well as highlighting potential benefits, the study pinpoints various implementation challenges, including potentially time-consuming compliance demands with host countries and the practicalities of structuring scheme benefits to take into account local social and labour laws.

However, it observes that the "true" cross-border IORPs are acting as catalysts for innovation in the European pension market by making the inclusion of employees located in different countries in a common pension arrangement a practical reality.

## Conclusion

The market for tax-transparent, cross-border pooling strategies is entering an exciting stage in its

development. Six years ago Northern Trust helped to launch the industry's first tax-transparent cross-border pooling solutions for multinationals through vehicles based in Ireland and Luxembourg. As a demonstration of industry growth, Northern Trust now services tax-transparent cross-border pooling funds with assets in excess of US\$65bn.

We expect the combination of regulatory developments, jurisdiction competition and broader pension fund trends will trigger further significant innovations and expansion. These developments will benefit the asset manager, multinational corporation, and insurer alike, with the ultimate winners being the investor/retiree.

Northern Trust urges any fund operator exploring new fund arrangements to carefully consider the use of "smart" tax-transparent vehicles as an integral part of their investment solution.

**Notes:**

<sup>1</sup> Based on Northern Trust's withholding tax analysis model. Results vary based on assumptions of yield and markets covered.

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