Northern Trust

Enhancing investment efficiencies via tax-transparent funds

A low-yield environment and regulatory requirements have increased the cost of doing business. Faced with these pressures, Northern Trust expects to see European insurers use asset pooling and tax-transparent fund vehicles in their investment businesses to maximise efficiencies, enhance performance and meet regulatory requirements

European insurance – A world of pressures

Insurers face distinct pressures that are increasing costs and bringing forth a more complex operating environment. These pressures include:

Solvency II

The Solvency II requirements for capital strength, balance-sheet consistency, risk-based capital, risk and solvency assessment, senior management accountability and supervisory assessment comprise the biggest regulatory challenges facing the industry in Europe. In particular, the requirement to reserve additional regulatory capital to what is currently required on balance sheets commensurate with the insurers' risk profiles of their investments, means sharp increases in the costs of holding equities and other asset classes considered to carry the most risk. High-quality government debt, other bonds with strong credit ratings and instruments with short maturity will, by contrast, be treated more favourably under Solvency II. This is likely to have an impact on asset allocation choices and the structures used by insurers.

The investment environment

Insurers must hold more capital as per the requirements of Solvency II to guard against the risk of insolvency. However, in a period of low economic growth and uncertainty, a need exists to balance the requirements of the capital regime with that of delivering income– in particular, insurers face the requirement to deliver income for support of the legacy book of business, which can include policyholder income guarantees. Finding and maintaining this balance between income generation and safeguarding against risk may be challenging.

Insurers, tax-transparent funds and asset pooling

The use of asset pooling through the operation of tax-transparent funds offers potential solutions to many of the challenges posed by this landscape, as well as an extremely versatile product solution for insurers. By holding investments including cross-border assets through a tax-transparent vehicle, insurers can pool together different investment assets for investors of multiple domiciles within a single vehicle. Suitable vehicles include: the Irish Common Contractual Fund; the Luxembourg Fonds Commun de Placement; the Dutch Fonds voor Gemene Rekening; and the UK Tax-Transparent Fund (shortly coming into effect).

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Advantages of utilising tax-transparent funds in this way can include the following:

Tax-transparency

Due to their scale, many insurance sector funds are already operating on a cross-border basis but are potentially tax-inefficient, with withholding tax applied at the fund level without regard to the underlying investor type or domicile. This may result in investors incurring higher effective tax rates than if they had invested directly in the market.

When traditional funds such as the UK open-ended investment company or Irish Variable Capital Company are used by insurance companies, taxation of the investment assets held within them is applied at the company level. However, in the case of tax-transparent funds, the vehicle is commonly structured so that the investor in the fund, rather than the insurance company, is the owner of the investment assets for tax purposes. Tax-transparent funds are, in this way, deemed to be fiscally transparent, with withholding tax being applied at the level of the fund's investors.

Underlying investors in that fund are then taxed according to their own domicile, allowing them to benefit from double taxation treaty arrangements that cannot be used if the fund is structured tax-inefficiently.

Institutional investors are often eligible for withholding tax reclaims, but cannot take advantage of these when their investments are held tax-inefficiently, exposing them to 'tax drag'. In this way, traditional collective investment structures can attract significant withholding tax rates – for example, equity withholding rates of 30% in the US or 35% in Switzerland – which often cannot be reclaimed. This can result in losses of between 50 and 90 basis points per annum through the poor choice of fund vehicle alone.

The advent of Solvency II offers the opportunity for insurers to restructure their investment operations in more tax-efficient ways and utilise the tax treaties their clients are entitled to, thereby maximising investment performance.

Research has found that a tax-transparent asset pooling vehicle can enhance returns by as much as $81 million on a $1 billion portfolio invested in broad market indexes over a 10-year period (see figure 1)[1].

Cost efficiencies

The expense of the Solvency II capital requirements will accelerate the need for insurers to become more cost-efficient. Northern Trust expects European Union life and pensions insurers to assess changing from policyholder to unit-holder models to help mitigate this capital adequacy requirement. In this environment, the consolidation of fund assets from multiple funds into a single tax-transparent vehicle offers obvious advantages of scale.

Servicing costs including investment management, custody and audit are potentially reduced by using asset pooling to consolidate fund vehicles, while reporting becomes more streamlined and transparent. For insurers, centralising their pool of assets should enable a similarly streamlined approach to asset administration, monitoring and oversight. Consolidating fund vehicles can also bring insurers greater purchasing power, which can help generate more cost-effective use of their investment managers when making appointments.

As well as Solvency II, myriad regulations are impacting the insurance industry from the UK's Retail Distribution Review to the US Dodd-Frank Act, and the incoming US and European requirements for central clearing of over-the-counter derivatives. In the face of such a cluttered regulatory landscape, maintaining separate compliance and administration processes for every fund will be inefficient, and consolidation into a tax-transparent vehicle offers significant efficiencies.

Legacy issues

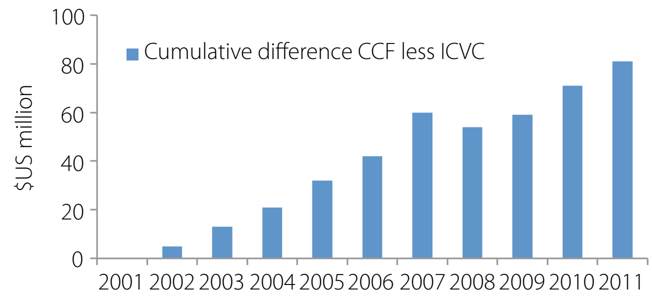
As insurers look to impose tighter cost and risk management on their businesses, legacy issues are increasingly likely to come to the fore. We expect to see life companies, in particular, take the view that their ageing fund structures – many of which will have been constructed for purposes such as individual stamp duties or capital gains tax – are now unwieldy, difficult to administer and no longer fit for purpose.

In our experience, insurers' investment portfolios often include large numbers of individual funds servicing individual markets. Many of these funds may have evolved sporadically via mergers and acquisitions, and these will be examined and consolidation considered in order to maximise synergies.

Because tax-transparent funds are cross-border in their scope, their use can help insurers become more efficient in replacing multiple funds. Rather than using a fund for each market, a single tax-transparent fund vehicle can be established, the components of which can then be adjusted to suit various regional market requirements without losing the overall benefits of fund rationalisation and tax-transparency. In this way, tax-transparent funds can represent a smarter way for insurers to distribute and deliver investment performance for their clients.

[1] Figure 1 shows how the additional returns obtained by a pension fund on US equities in the Irish Common Contractual Fund compared to an Irish Investment Company with Variable Capital (ICVC) accumulate over the 10-year period

1. Additional cumulative returns in the Irish Common Contractual Fund (CCF) over 10-year period (US equities)



Source: Northern Trust

Facing the future – Tax-transparent funds and the insurance industry

Pooling assets in a tax-transparent fund vehicle will play an increasing role in helping insurance companies meet the challenges of the low-yield environment and increased regulatory burden, through the following:

- Tax-transparency – The elimination of tax drag facilitates improvements in investment performance that insurers can set against the increased cost of doing business.
- Cost-efficiencies – Rationalisation brings reduced servicing, administration and reporting costs while affording greater purchasing power through consolidation of fund vehicles.
- Legacy issues – A flexible, intelligent solution of delivering performance for clients while tackling inefficient or outdated fund structures that are no longer fit for the purpose.

For more information, visit www.northerntrust.com/eu-insurance. This article is extracted from a forthcoming Northern Trust insurance industry white paper

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