

Navigating DC Fund Structures

Seeking directions on the best fund wrapper for DC pensions



Is there a best form of fund wrapper to use for UK defined contribution (DC) pensions?

Pooled funds are, of course, convenient for investing DC pension assets, but they come in several subtly – but importantly – different forms. Today’s dominant form is to use a life insurance policy wrapper – what we call “life funds”. Life funds emerged out of the once dominant defined benefit (DB) pension industry, but changes in fund distribution practices, regulations and innovations in fund manufacturing make life funds less appealing for DC members.

This paper recaps the arguments on four common fund wrappers which are life funds, reinsured life funds, Open Ended Investment Companies (OEICs) and Tax Transparent Funds¹ (TTFs). It then replays the backstory and discusses the latest chapters in the unfolding story.

This discussion paper has been commissioned by Vanguard Asset Management from the Life & Financial Services team of Hymans Robertson LLP. It is intended for investment professionals involved in the delivery of UK defined contribution pensions, including trustees, independent governance committees (IGCs) (noting that both trustees and IGCs have legal obligations under the Pensions Regulator’s DC Code of Practice to safeguard members’ interests in DC schemes), fund manufacturers and fund distributors. It is not intended for individual retail investors, nor as formal advice.

Navigation

To help you get your bearings, we have signposted the journey as follows:

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|  | How did we get here? |  |  | Not all fund vehicles are tax-efficient |  |
|  | Mapping the end-to-end investment journey |  |  | Stronger regulatory requirements |  |
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You can also find a glossary of the technical terms used in this paper at annex A. These defined terms are capitalised.

¹There are several types of TTFs such as Authorised Contractual Schemes (ACS), Common Contractual Funds (CCFs) and Fonds Commun de Placement (FCP). For consistency throughout this paper, we will refer to TTFs as their collective name. All the capitalised terms in this paper are defined in the glossary in Annex A.

Key points

Funds that have been wrapped up in insurance contracts look increasingly at odds with consumer demand for investing in different manufacturers' funds (sometimes requiring opaque reinsurance treaties) and are also at odds with today's raised regulatory standards for DC pension schemes. As a result, other investment vehicles are commonly used, such as OEICs.

- **Not all pension investments are tax optimised:** The typical reduction to a members' retirement savings from investing in global equities via tax-inefficient OEIC funds is 5% over a 30-year period. This potential tax drag is set to increase as the period of investing lengthens with later retirement ages and the abolition of the requirement to buy an annuity at retirement. Over a term of 30 years, this could mean that a fund that was targeted to reach £250,000 would actually be £12,500 short at a value of £237,500.
- **Transparency:** To visualise and understand who does what, we encourage providers to sketch their end-to-end investment process, including all the different intermediaries in the chain. This will help trustees and independent governance committees to discharge their requirements under the tPR's DC Code of Practice and address the increased need for transparency that regulators are requiring.
- **Tax Transparent Funds (TTFs) growing in popularity:** Where new breed of TTFs, such as CCFs and ACSs, can be offered on a competitive basis to life funds, platform providers are likely to have a growing preference for TTFs to mitigate counterparty risk concerns and simplify compliance with the tPR's DC code of practice.

Douglas Anderson

douglas.anderson@hymans.co.uk

Ross Evans

ross.evans@hymans.co.uk



How did we get here?



To get a sense of perspective on today's DC pension offerings, take a look back at the development journey of today's DC pension funds over the last 40 years. There have been many catalysts for change, leading to greater customer choice.

Most funds marketed to DC pension schemes today were originally conceived for defined benefit (DB) pension schemes. DB pension scheme investments are simpler to deliver, since the members' benefits are not affected by the investment return, and the number of organisations involved in the delivery tends to be smaller.

A map of the journey showing how we got from funds designed for DB schemes to the profusion of different DC fund choices available today is shown overleaf.

Three broad themes emerge:

1

Provider specialisation: life insurers, the once dominant pension providers, have carved out their investment management capabilities into separate units, so creating separate manufacturing and distribution operations. Whilst trustees may still contract with a "one-stop shop" operation, there will typically be many subcontractors and interdependencies involved in the delivery;

2

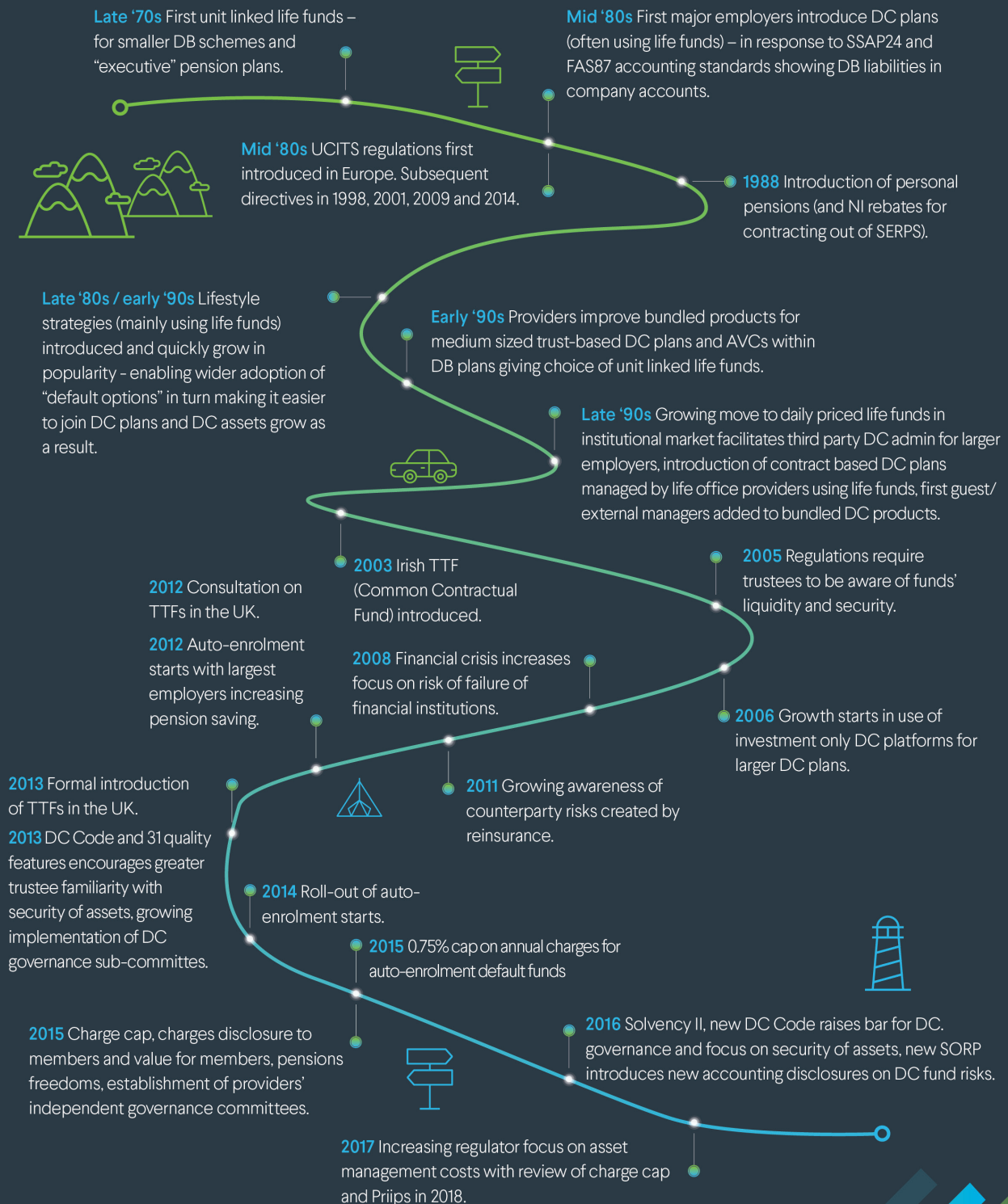
More providers: the growing popularity of DC pension saving, heightened by auto-enrolment legislation, means greater DC savings volumes. This has attracted new entrants (such as asset managers) into the DC market who in turn look for differentiation in their proposition; and

3

Fund innovation: a new fund wrapper, known as a Tax Transparent Fund (TTF), has emerged, claiming best of breed features in combining tax-efficiency and security.

How did we get here?

The fund structure journey for UK defined contribution pension schemes



Mapping the end-to-end investment journey



Trustees and governance committees are legally required to understand the structures that are being used by their product providers to deliver the end investment exposure. Different fund architectures have potentially material implications for their members' ultimate retirement pots (mainly from tax efficiency) and introduce different levels of Counterparty Risk. Ask your provider to sketch the end-to-end process underpinning the delivery of your members' DC investment choices.

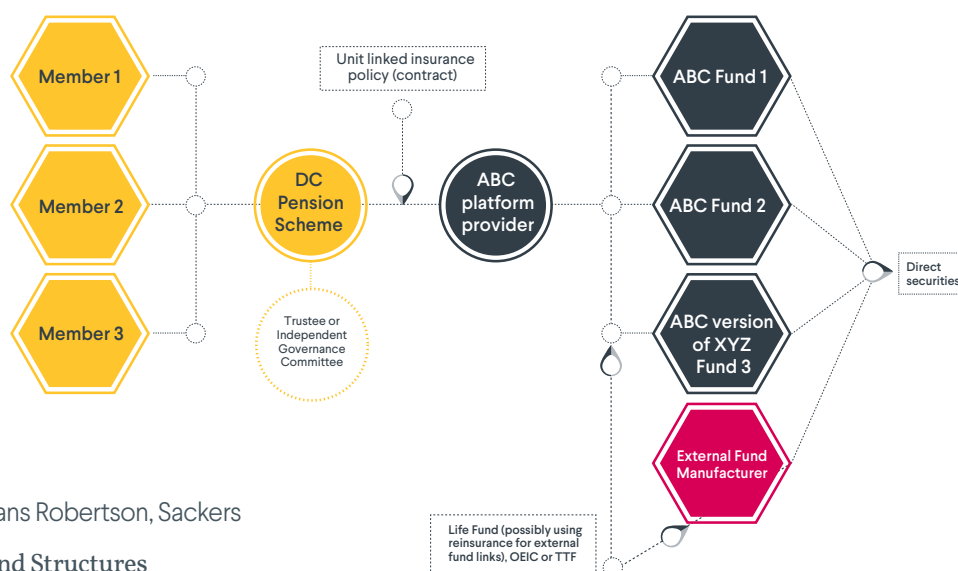
Most DC pension savers prefer to save through managed portfolios of assets (funds), rather than holding direct securities². Investment in these funds may be enabled through fund platforms, which act as an interface between the Fund Manufacturers and the DC pension saver.

A typical chain of steps linking the DC pension saver to the direct securities that are held at the opposite end of the chain are summarised in the sketch below. This is a two-way street along which information is being passed at least daily, and sometimes more frequently.

But there are many potential variants on this process. Where it starts to get complicated is where the funds may be offered in different types of Fund Wrapper: Life Funds,

Reinsured Life Funds, Open Ended Investment Companies and Tax Transparent Funds. And these funds have some subtly different characteristics which are explored throughout this paper.

To explain the Reinsured Life Fund, this is where life insurers enter into Reinsurance agreements under which the lead company does not own the underlying securities, but has a contractual promise of getting a return equivalent to the performance on the underlying securities. To complicate things further, several leading Fund Manufacturers are regulated as insurers. This has the potential to create interdependencies between Fund Manufacturers or between an external Fund Manufacturer and the lead Pension Provider where the two entities are life insurers.



² Source: Hymans Robertson, Sackers

Asset security: what's under the bonnet?



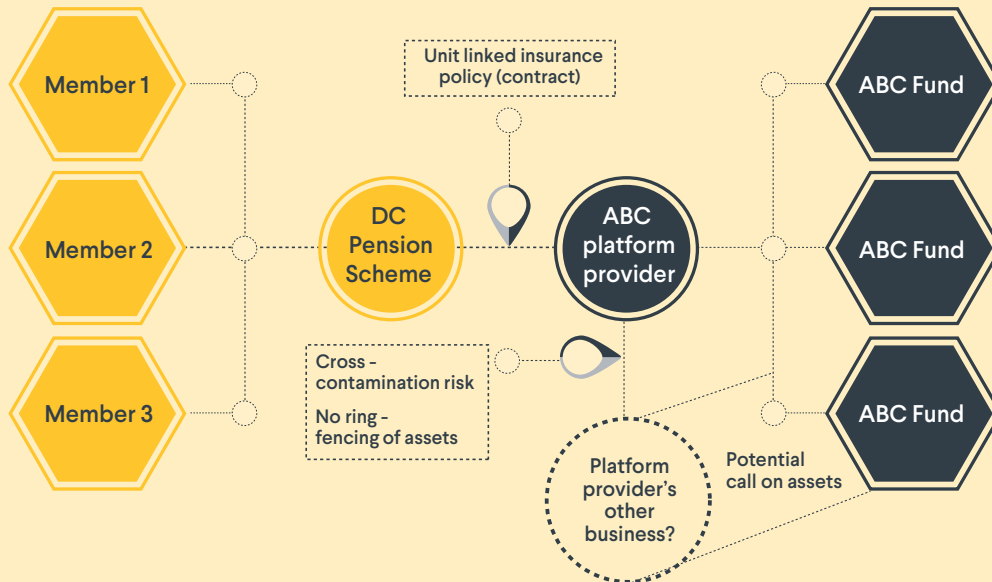
Trustees and governance committees are required under their DC responsibilities to members to research and understand security of assets to see how their members' investment promise is actually being delivered, and particularly how any Counterparty Risk (or the security of assets) is being managed by the entities in the chain. Life funds – and particularly reinsured life funds – merit particular attention. They are also required to communicate these findings to members.

The specialisation of the asset management industry into separate fund manufacturing and distribution businesses, combined with the cross-selling of others' products, has introduced dependencies on counterparties. Although we have experienced the global financial crisis and associated bailout of AIG in recent memory, the insolvencies of insurers are rare events and regulatory measures on capital adequacy have become even more stringent after 2008. However, the failure of a counterparty (namely the life insurer or reinsurer) to deliver on their promises, whatever the low probability, could put a member's assets at risk of partial or complete loss and ultimately jeopardise their retirement plans.

Consider two example scenarios.

Scenario 1 – Life Funds offered by a diverse life insurance business

Consider the following diagram:



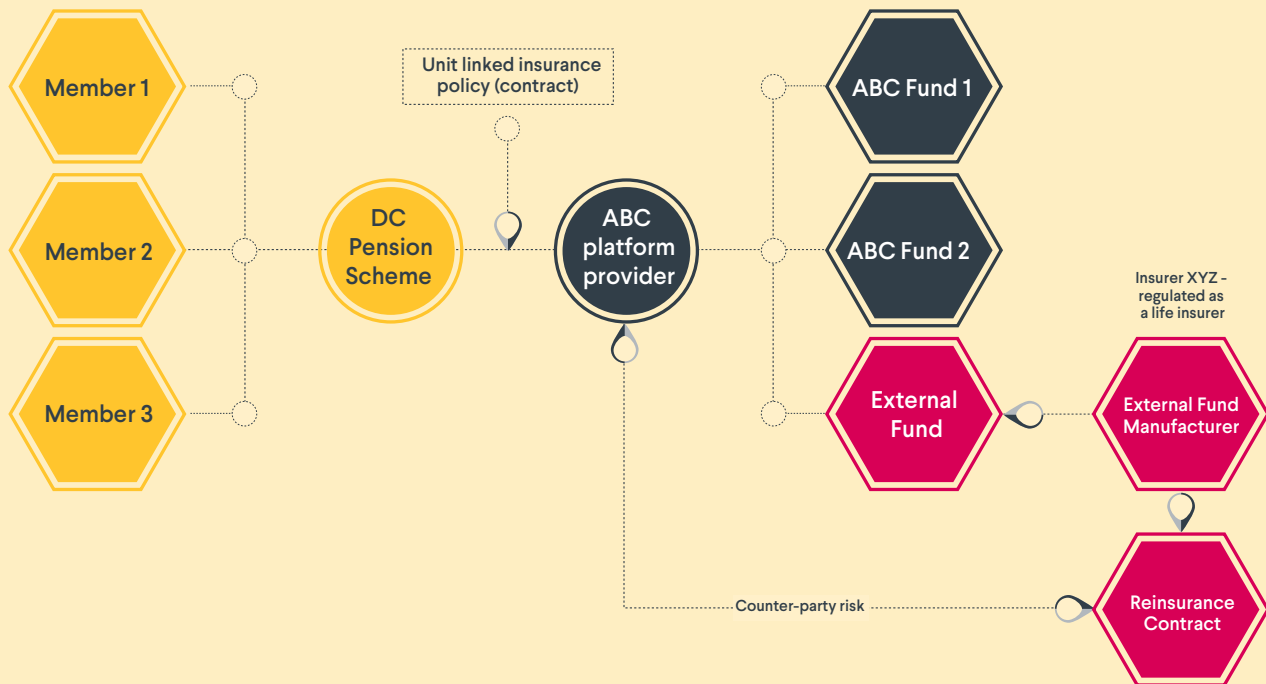
In this case, a pension scheme holds the life policy of a Pension Provider (ABC), which is a life insurance company. The Pension Provider has a direct link to each of the underlying ABC pooled funds, which are Life Funds.

ABC is an insurance group that writes traditional life policies alongside annuities and also offers asset management through unit-linked funds from the same legal entity. Within the asset management arm, they manage with-profits products that offer guarantees. Through a combination of industry and economic factors, ABC is facing insolvency.

Remember, the above pension scheme does not own a share of a ring-fenced fund (a legal separation between two entities – in this case, between the ABC Pension Provider and ABC's other business interests); instead, the scheme owns a promise to be paid from the contracting insurance company as a whole. The concept of ring-fencing only applies to the total pool of assets under the ABC life insurance platform – it does not differentiate between the funds dividing the asset pool. Therefore, a life insurance fund structure gives rise to cross-contamination risk – the risk that the Pension Provider writes business or manages products that could, in the event of failure, potentially have a claim on the assets of the ABC funds, affecting the members of the pension scheme. This is different to Counterparty Risk – the risk of insolvency of the Pension Provider or their unwillingness to fulfil the contractual promise of the terms of the insurance policy.

Scenario 2 – Reinsured funds: A Pension Provider offering a third party’s Life Funds

Consider the following diagram:



The separation of administration and investment services through open architecture fund platforms has complicated the situation further, with several insurers offering fund platforms, sometimes called fund supermarkets. These structures can lead to counterparty risks, particularly where insurance funds are involved.

One practice is for an external asset manager to make its funds available to the Insurer ABC in the form of a Life Fund. This provides certain tax advantages which we will consider later. Let us assume that the administrator is another life insurer, which takes up the offer through a reinsurance contract. That is, the end-customer buys a Life Fund with insurer ABC and the administrator takes out a reinsurance contract with the insurance subsidiary of an external Fund Manufacturer (Insurer XYZ)

The reinsurance contract allows Insurer ABC to set up a unit-linked fund whose investment performance matches, that of Fund Manufacturer XYZ’s fund. The pension scheme holds a Life Fund with Insurer ABC, who promises to match the performance of XYZ’s fund. The following insolvency scenarios would create problems with this type of arrangement:

- **Insurer ABC becomes insolvent.** This situation reverts back to Scenario 1 described in the previous diagram.
- **Insurer XYZ becomes insolvent.** In this case, Insurer ABC would have to make good to its customers any resulting losses, unless this risk had been clearly spelled out to its customers (in which case it is, in principle, possible that customers would suffer as if they had contracted directly with XYZ’s insurance subsidiary but potentially without the benefit of the Financial Services Compensation Scheme). If Insurer ABC could not cover the resulting losses, causing its own insolvency, then customers of the internally managed funds shown in the diagram would also suffer – remember, these are also Life Funds and are not ring-fenced either.

Not all fund vehicles are tax efficient



Different investors have different tax statuses. Investment opportunities are now available worldwide. Not all Fund Wrappers maximise the tax privileges of UK pension fund investors, particularly in recovering withholding taxes on overseas dividends. This hidden tax drag might *typically reduce returns by 0.3% per annum*, half as much again as typical provider charges. And the effect compounds up to materially reduce the ultimate retirement pot of the member. Over a thirty year period, a pension fund could be 5% lower than it would have been in a fully tax-efficient wrapper.

Trustees and governance committees should check that they are not incurring an avoidable tax drag.

From a tax perspective:

- Life Funds that invest directly, Reinsured Life Funds and TTFs deliver superior tax efficiency for pension investors.
- OEICs, on the other hand are known as tax opaque, rather than tax transparent, pooling vehicles, since they do not differentiate between the tax statuses of different investors. The tax opaque characteristic still remains for pension investors even when the OEIC is wrapped inside a Life Fund and applies in particular to the withholding tax section below.

Pooling and tax transparency

Taking a step back, pooling is the term used to describe the aggregation of different investors' assets into a single fund vehicle. Pooling can take place through a vehicle which is opaque (i.e. does not differentiate for tax purposes), or one which is regarded as tax transparent. The pooling of assets in a fund which is transparent for tax purposes means that income and capital gains / losses from investments made by the fund accrue to each investor in proportion to their holding in the fund, without changing their character, source and timing. In other

words, the fund is "looked through", and investors are treated for tax purposes as if they held their proportionate share of the underlying investments directly.

Withholding tax

Many countries withhold taxes at source from dividend income, which may not be recoverable whether or not the investor is tax-exempt or tax-paying. These tax rates can vary across country, type of investor and type of fund. For those countries where bilateral tax treaties are in place, relief will not be available to tax-exempt investors in OEICs, because the treaty would be applied to the vehicle rather than to the investor. A tax-exempt UK investor, such as a member of a DC pension scheme, seeking to invest in global equities is likely to suffer a significant tax penalty as a result of the large proportion of an OEIC's global equity holdings that are normally allocated to US equities, the dividends from which will be subject to withholding tax. It will not be possible for tax-exempt investors in the fund to make use of the tax treaty to reduce the tax withheld at source. The materiality of the tax drag is shown in the box on the next page.

Tax Transparent Funds – the solution?

A TTF offers investors similar tax treatment as if they held the investments directly while also providing the economies of scale and diversification benefits of pooling. Whilst outside the scope of this paper, the structure of tax-transparent funds can also be UCITS-compliant and therefore afford underlying investors the comfort of UCITS regulations and protections, such as the

ring fencing of underlying assets by the custodian. So tax-advantaged investors such as DC pension schemes can ensure they receive the appropriate tax treatment, unlike the situation with OEICs as described above.

However, the complexity and costs of setting up and operating a TTF relative to an OEIC need to be taken account, especially for smaller funds.

Quantifying Tax Drag

Consider the following simple member outcomes analysis.

The average dividend yield for US equities is currently 2%. If we assume a rate of withholding tax of 30% (as it would be in an Irish OEIC fund wrapper), the tax payable on a US equity allocation is 0.6% a year. Moreover, let's assume the average proportion of US equities in a global equity allocation is 50%, then the withholding tax recoverable within a global equity life fund or a TTF is in the order of 0.3% a year. **This is a direct benefit to a member's DC at-retirement pot, ultimately to their retirement income,** and compounds up every year.

Given that the above analysis is simplistic, it may help to show the difference between member outcomes by considering a range of different tax recoveries (for Life Funds / TTFs) and tax drags (for OEICs). We illustrate the long-term effect of tax drag on a portfolio in the following table:

Annual tax drag to overall portfolio from investing in overseas assets through an OEIC (basis points)	Estimated reduction to at-retirement fund (after 30 years) (TTF vs OEIC)
10 bps	-1.7%
20 bps	-3.4%
30 bps	-5.2%
40 bps	-7.0%

So, taking the 30 bps drag number, someone targeting building up a fund at retirement of £250,000 would be looking at contributing an extra £12,500 if they saved through an OEIC rather than a Life Fund or a TTF. Or, to put it another way, the member would find that they had a pot size of £12,500 lower at only £237,500.

Note: In the above calculation, the investment product and underlying allocation is the same between a member in the OEIC vs the TTF. Our assumptions include the following:

- We assume a salary growth of 3.5% a year and a time horizon of 30 years.
- We do not consider any other tax recoveries from other countries (other than the US).
- We do not consider the differences in the operating costs of using a TTF relative to an OEIC. Our understanding is that the cost of running an OEIC is lower than for the TTF, all else being equal, but that the cost differential reduces as funds under management increase.
- We assume that the member invests at the start of their career (with a starting pot of zero) in a global equity index with a long-term return assumption of 7% a year (2% dividend yield and 5% long-term capital appreciation).

The future looks much brighter for TTFs as their qualities become better appreciated. We have compared the key features of all the common types of fund vehicles on the market in Annex B.

Stronger regulatory requirements



Over the past four years, there have been significant developments in the world of DC pensions, most notably the growth in new contributions as the scope of auto-enrolment has been rolled out. The number of employers going through the auto-enrolment process was 2,256 in 2013 – the number is now 206,137 in 2016. As at July 2016, 6.5 million employees have been automatically enrolled, which was up from 5.4 million in August 2015³. The growth in DC pension saving has been accompanied by significant regulatory change. We highlight four changes which are particularly relevant to the choice of Fund Wrapper:

- a) **At-retirement strategies.** The compulsory purchase of an annuity has been abolished, meaning that DC members are likely to be invested in funds for longer, increasing the potential drag on returns from any tax-inefficient funds.
- b) A **greater focus on value** delivered to DC members, rather than just charges. Recent research conducted by NMG has identified good returns and security of assets as the two attributes that members most highly value. This makes the tax efficiency of fund structures particularly relevant from the perspective that it can improve member outcomes. It also brings security of DC assets to the forefront of any discussion focused for value for members.
- c) The **Solvency II** risk management regulation of insurers, which went live in 2016, is affecting some underlying components of the end-to-end DC investment process, particularly in relation to counterparty risk.
- d) An increased focus on **DC pension governance**, particularly around security of assets. This includes the obligation of trustees to communicate with scheme members on asset security. Further, the Pensions Regulator expects trustees to ensure that the benefits of scheme members are protected and that the investment funds offered by the scheme continue to be appropriate for the membership⁴.

³Taken from The Future Book 2nd Edition 2016: <http://www.pensionspolicyinstitute.org.uk/publications/reports/the-future-book-unravelling-workplace-pensions,-second-edition-2016>

⁴Taken from the tPR & FCA joint publication <https://www.fca.org.uk/your-fca/documents/workplace-defined-contribution-pensions-guide>

(a) At-retirement strategies

Whilst there is still a strong case for annuitisation, particularly at higher ages, we expect retirement savings to be invested in funds for, on average, five to 10 years longer than before. This makes avoiding a tax-inefficient fund more important. The tax drag on a ten-year investment is the equivalent of a 3% loss due to paying tax unnecessarily. Please see the Tax Drag example in the previous section.

(b) Focus on DC member charges

A 0.75% annual charge cap for all member-borne costs applies to the default option of an auto-enrolment qualifying scheme. The level of the charge cap will be reviewed in 2017/18. Any reduction in the cap or, perhaps more likely, its extension to include transaction costs can't be ruled out. Broadening the scope of the cap to include transaction costs, would make it harder for some funds to continue to qualify as default funds (without cutting providers' profit margins) and makes it more important that tax recoveries are maximised.

The entire DC industry is starting to think about value for members in a cost vs benefits framework, rather than just looking at charges on their own. Whilst Life Funds have been cheaper because of their economies of scale, the security benefits and the regulatory capital considerations of fund structures such as OEICs and TTFs need to be factored into a discussion on value for members. Whilst OEICs are more common and widely available, the tax efficiency of a TTF provides clear benefits that also need to be factored into the discussion.

Annex B contains a more detailed comparison of the key features of the difference types of Fund Wrapper.

(c) Solvency II and Counterparty Risk

The widespread use of Life Funds, when DC in the UK was in its infancy, didn't anticipate:

- the popularity of third-party fund managers providing funds on an insurance platform; nor
- the strengthened risk-based regulatory regime in the aftermath of the 2008 financial crisis.

The implementation of Solvency II has increased providers' attention on counterparty risk, particularly where asset managers (regulated as life insurers) are offering other insurers' Life Funds (see section 3). The requirement to hold capital has encouraged Pension Providers to manage their counterparty risk more actively (eg minimising concentrations of exposure to particular Fund Manufacturers).

The consequences are **that counterparty risks are becoming material for those major insurers who are DC Pension Providers as the volume of Reinsured Funds climbs into the £billions.** Whilst the probability of a counterparty default is very low, it is not zero and the regulator would also attest to this judging from the additional capital requirements. We have already seen several major insurers restructure its funds and choice of fund managers to contain its counterparty risks and others are starting to follow suit.

Whilst it's still early days, **we are seeing that the these pressures are creating a distinct order of preference for OEICs and different types of TTFs over life funds in terms of what providers are willing to wrap on their platforms.**

(d) Focus on governance and value

Recent pensions legislation and the Pensions Regulator's recently released Code of Practice No. 13⁵ have raised the bar for the governance of DC pension plans. The table below summarises the areas that are particularly relevant in distinguishing between the advantages and disadvantages of certain fund structures:

Reference	Requirement	Impact
Security of assets tPR Code of Practice No. 13, Section 108	The law requires trustees to give due consideration to asset protection and to understand what would happen in the event of a problem.	Consideration of security of assets and for trustees to understand what would happen in the event of a problem is now a regulatory requirement . We present two scenarios in Section 3 to illustrate the uncertainties that appear to be implied in the event of insolvency facing a life insurer providing life funds.
Communication with Members tPR Code of Practice No. 13, Section 108	Trustee boards need to assess the extent to which, and in what circumstances, any loss of scheme assets might be covered by indemnity insurance or similar arrangement, or a compensation scheme such as the Financial Services Compensation Scheme, and to communicate the overall conclusion about the security of assets to members and employers .	In the current environment, there is an increasing reputation risk and possibility of litigation if trustees fail to understand the governance issues surrounding fund structures and to increasingly factor security of assets into their criteria for provider / fund selection.
Value for Members tPR Code of Practice No. 13, Section 115	Value for members does not necessarily equate to 'low cost', notwithstanding that the law puts in place certain charge limits on some schemes. A scheme which fully complies with the charge controls will not necessarily provide good value for members. In our [tPR's] view, charges and transaction costs are likely to represent good value for members where the combination of costs and what is provided for the costs is appropriate for the scheme membership as a whole, and when compared to other options available in the market.	This is an area which many trustees are grappling with, given the lack of transparency (implicit investment costs being one such area) and lack of comparison data. The charge cap and implicit investment costs faced by members have opposing effects in the debate about the appropriateness of fund structures – whilst life funds are generally cheaper, they have risks that should be considered from an overall value for members' perspective.

How Safe Are Your DC Assets – A Guide

A working party sponsored by the Association of Member Nominated Trustees produced a leaflet in February 2016 (and recently updated in September 2016) titled: "How safe are your DC assets?" This document contains a particularly useful discussion on the limitations of the Financial Services Compensation Scheme. This useful resource for trustees also lists several challenging questions for trustees to ask their providers covering:

- The legal structure of the funds;
- What could go wrong if the entity holding the fund collapsed;
- What controls are in place to prevent things going wrong; and
- What protections for members are in place should things go wrong?

The questions do not include tax efficiency, but we believe it is sensible to consider tax efficiency too when reviewing the type of Fund Wrapper used given the material impact that tax can have on the final pension pot and ultimately, the income in retirement.

⁵<http://thepensionsregulator.gov.uk/codes/code-governance-administration-occupational-dc-trust-based-schemes.aspx>

The next steps for Trustees and advisers



The development journey of Fund Wrappers has taken several twists and turns over the last 40 years. What was best of breed for DB funds in the 1970s no longer looks best for DC funds distributed through increasingly complex and opaque networks of manufacturers and distributors.

Demand for greater member choice has created a complex investment network, much of it hidden beneath the surface. In normal conditions, this complex system serves the needs of individual investors well. However, if one of the underpinning elements of the infrastructure should fail – such as a reinsurance treaty – normal service cannot be guaranteed.

Before embarking on the next stage of your journey, it is important that trustees understand how their fund vehicles would perform in challenging terrain. The Pensions Regulator is asking trustees to shine a torch under the bonnet, and to communicate their findings with members.

To protect members of DC Pension Schemes, we suggest you make three high-level requests of your Pension Provider to understand who does what, whilst also checking that tax efficiency and member security are being delivered:

1. **End-to-end process:** Sketch, at a high level, the end-to-end process between the individual member and the investment in an individual business, for default and self-select funds. Identify all the intermediary organisations (eg fund platforms, internally manufactured funds, externally manufactured funds), the types of Fund Wrapper used and the style of contractual relationships that exist between the organisations.
2. **Tax efficiency:** Investigate with your adviser and provider whether your members are unknowingly paying unnecessary tax.
3. **Counterparty Risk:** Do your scheme members have any exposure to risk flowing from any counterparties in your end-to end process? If so, please comment on its materiality, the steps you are taking to prevent such an occurrence and how you would manage the failure of a counterparty.

Annex A: Glossary

Counterparty Risk is the risk to each party of a contract that the counterparty will not live up to its contractual obligations. In most financial contracts, counterparty risk is also known as default risk. In the case of DC pensions, counterparty risk may arise where, for example, the Pension Provider offers another Fund Manufacturer's fund through its contract with the scheme's members or a provider puts its branding on a white-label fund manufactured by another asset manager. Were a counterparty to default, a complex insolvency would be likely to follow, potentially creating delays before units can be realised and uncertainty for scheme members. If the Pension Provider allows investors to cash in units, without access to the underlying assets, this may cause cash flow strains (liquidity risk).

Fund Manufacturer – asset managers who develop the fund concept and then manage the investment process to the pre-agreed parameters of the particular fund. The same portfolio of underlying assets may be marketed to different types of investors (pension and non-pension forms) with different Fund Wrappers. The Fund Manufacturer will be responsible for managing tax recoveries.

Fund Wrapper – a collective name for the group of legal structures that go around the underlying portfolio of assets, including Life Funds, Open Ended Investment Companies and Tax Transparent Funds (see Annex B). The choice of Fund Wrapper will be made by the Fund Manufacturer and will determine what type of investors can buy it, how tax efficient it will be, and potentially how it is affected by Counterparty Risk.

Life Funds – Pension Providers that are regulated as life insurers can create life fund(s) that buy securities in the marketplace. The DC pension savers become insurance policyholders in the fund. The Life Fund's assets may not be ring-fenced for the policyholders.

Open Ended Investment Companies – The Fund Manufacturer creates a fund that allocates units in its underlying assets to the individual pension savers. The OEIC is ring-fenced from the rest of the Fund Manufacturer's business and also provides additional layers of protection and governance through compliance with the UCITS framework.

Pension Provider – financial services organisations marketing DC pension services to employers and individuals, these may be insurance companies, asset managers, brokerages, master trusts etc. Business strategies tend to focus on distribution. Funds may be manufactured in-house or sourced externally, sometimes using a third-party administrator to manage the investment and disinvestment process for scheme members.

Reinsurance is insurance that is purchased by an insurance company from one or more other insurance companies (the "reinsurer") typically for risk management. Reinsurance treaties may also be used between insurance companies (and between subsidiaries of the same insurance group) to enable one insurance company to offer another company's Life Funds – known as a Reinsured Life Fund.

Tax Drag – the reduction in annual return to a tax-advantaged pension investor from investing in a fund that does not deliver full tax recoverability, typically on non UK dividends.

Tax Transparent Funds (TTF) – There are several types of TTFs available, such as authorised contractual schemes (ACS) domiciled in the UK, common contractual funds (CCF) domiciled in Ireland and Fonds Commun de Placement (FCP), which are domiciled in Luxembourg.

Annex B: Defining characteristics of Fund Wrappers

Investment is through a lead insurer (ABC) acting as a Pension Provider with links to a different Fund Manufacturer (XYZ), also an insurer as below.

	Direct Investment in UK Life fund	Reinsured Life Fund	Open-Ended Investment Company (OEIC)	Tax Transparent Fund (TTF such as CCF or ACS)	Direct holding
Investor's Ownership	Has a contract of insurance with insurer, whose claim value mirrors the return on fund.	Pension Provider ABC has a reinsurance contract with insurer XYZ.	Owens units in a fund which owns assets.	Owens share of fund which owns assets.	Individual owns assets themselves.
Partitioning of Assets	Separate internal accounts maintained, for purpose of measuring returns. Legally, assets are part of general life insurance resources of insurer.	Insurer XYZ will also have separate internal accounts and legally, assets are part of general life insurance resources of insurer XYZ.	All fund holders share in a legally separate fund.	All fund holders share in a legally separate fund.	Complete
Fees	Historically lowest.	Low but will likely rise for external fund links as opposed to investing direct.	Low but will likely rise for external fund links as opposed to investing direct.	Low but will likely rise for external fund links as opposed to investing direct.	Higher due to lower economies of scale.
Tax drag, esp. overseas	Low, but potentially complex.	Low, but potentially complex.	Mutual fund may not be able to recover withholding tax and end-investor cannot make a separate claim.	Tax transparency reduces tax drag on overseas equities for eligible investors.	Withholding taxes will depend on whether the investment is made in a jurisdiction that gives the pension investor some or complete (e.g. US) relief.
Fraud risk	Low, large insurance group would make good manageable losses from capital resources.	Low as both parties will be large insurance groups.	Low, with trustee and custodian arrangements in place.	Low, with trustee and custodian arrangements in place.	Highly dependent on arrangements.

cont...

	Direct Investment in UK Life fund	Reinsured Life Fund	Open-Ended Investment Company (OEIC)	Tax Transparent Fund (TTF such as CCF or ACS)	Direct holding
Insolvency of Fund Manufacturer	Protected by capital but exposed to all risks borne in the contracting entity Insolvency situation highly dependent on contractual details, but losses and payment delays could be consistent with those of other customers.	XYZ protected by capital as in ABC, but less transparent. Situation highly dependent on subcontracting arrangements and losses and payment delays could be expected unless lead insurer (ABC) covers losses of insurer XYZ.	Client (fund) assets are held by a separate custodian and thus protected from problems in the fund manager's business.	Client (fund) assets are held by a separate custodian and thus protected from problems in the fund manager's business.	None
Status under Financial Services Compensation Scheme ¹	Eligible investors ² receive 90% of their investment, without upper limit.	Eligible investors would be able to claim in respect of default by the lead insurer but neither the investor nor the lead insurer would be able to claim in respect of default by insurer Y.	Eligible investors in UK domiciled funds receive 100% of the claim to a limit of £50,000. UCITS-compliant OEICs offer underlying investors the comfort of UCITS regulations and protections	An Irish domiciled investment will not be covered by the (UK) scheme. At present the scheme in Ireland only applies to entities which are regulated under MiFID and does not extend to such funds, although these funds are regulated by the FSA. UCITS-compliant TTFs offer underlying investors the comfort of UCITS regulations and protections	Depends on the eligibility of the investor and the nature of the investment held.

1 Information based on our understanding of the scheme at time of writing. See www.fscs.org.uk.

2 Eligible investors will broadly be individual retail investors and small corporate investors but for insurance funds can also include other institutional investors – investors should ensure they are aware of the protection available to them.



Douglas Anderson

Partner and founder of Life and Financial Services

Douglas is a partner, a Fellow of the Institute and Faculty of Actuaries, and a Chartered Enterprise Risk Actuary. He is an entrepreneurial actuary, with a passion for enterprise risk management. His actuarial career spans thirty years and has been a partner in Hymans Roberson for approaching twenty years. Douglas advises a diverse range of clients, including insurers, reinsurers and pension schemes. He founded Hymans Robertson's Life & Financial Services practice in 2011.



Ross Evans

Partner and Head of Insurance Investment and ALM

Ross leads Hymans Robertson's Insurance Investment & ALM Services, within the Life and Financial Services team. He is a Life Actuary with over 15 years' experience across consulting, industry and investment banking. Ross has significant experience helping insurers manage their investment and ALM activities, implement aspects of Solvency II, such as the Matching Adjustment, design the outsourcing of insurance assets, and advising on hedging and capital management strategies.



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