Property and asset pooling

An opportunity for the Authorised Contractual Scheme (ACS)

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Insurance and real property – a tax transparent future

The insurance industry is poised for transformation. Regulations, newcomers with disrupting technology, and fierce competition for best in class investments with lean operating models are testing the resilience, strategies and efficiencies of those in the industry.

UK insurers are increasingly turning toward real assets to produce steady cash flows and long-term appreciation, while balancing regulatory liquidity demands and policyholder cash outflows. However, investing efficiently in real assets for UK insurers is challenging. Savvy insurers are looking beyond standard segregated mandate investment structures toward sleeker and potentially more efficient asset pooling solutions, such as the UK's Authorised Contractual Scheme (ACS).

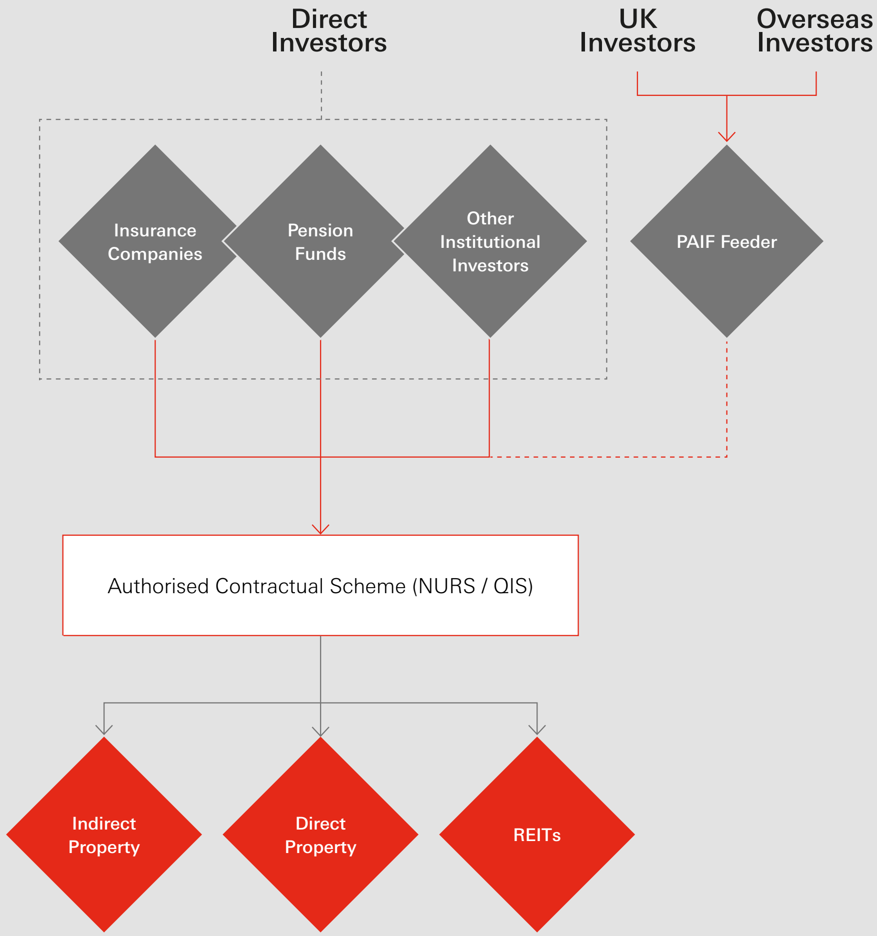
Product managers must innovate

Insurers' product teams must look at optimising operating models in terms of fund types, asset classes and investor demand for new and legacy products alike.

While legacy funds are potentially in decline, holding real assets intended for long-term investment purposes would benefit from new distribution channels. As such, insurers will be stuck between a rock of policyholder cash outflows and a hard place of long-term investment strategy.

The ACS is a tax transparent pooling vehicle formed in the UK, which marries the economies of scale, unitisation, distribution benefits and operational oversight of traditional collective investment schemes, with the added benefit of being transparent for tax purposes. Life insurers could look toward innovative fund structures, like the ACS, to overcome existing operating hardships and future growth.

In 2017, HSBC helped launch the largest UK property ACS: The Royal London UK Real Estate Fund. Seeded by Royal London Mutual Insurance Society Limited, HSBC continues to serve as the depositary, registrar, transfer agent, and administrator of the fund. The fund's launch prompted moves across the UK insurance industry to find similar innovative solutions to unitise illiquid properties in efficient operating models to diversify product offerings. Large scale restructuring projects of this nature are complex; however, operational model refreshes are an opportunity to repaper contracts using large pooling vehicles, whilst renewing focus on investment returns from direct and indirect properties. An example structure of a property ACS fund is shown in the diagram.



The intersection of a real asset strategy, ACS operations and efficiency

The Global Financial Crisis of 2007-2009 altered the economic environment insurers operate in, with the advent of new targeted regulations across the globe[1].

The more recent Covid-19 pandemic has impacted almost every stretch of human life, notwithstanding the global economy. Interest rates are at or near zero across numerous countries (or indeed negative)[2], oil prices are highly volatile[3], and global equity indices hit day-on-day record declines in value[4]. Insurers, especially life and pension funds, are keen to play a role in finding solutions for long-term oriented institutional investors to weather tempests like these.

The graphs from Solvency II data on the next page illustrate the propensity for UK-based insurers to allocate investment toward property (real assets) versus other investments.

[1] https://www.imf.org/external/pubs/ft/wp/2014/wp1446.pdf

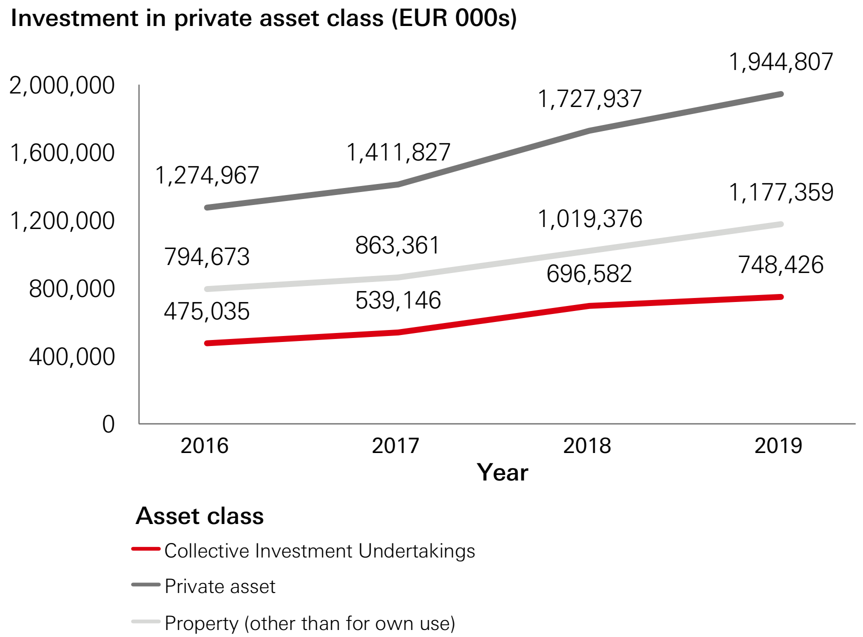
[2] https://www.forbes.com/sites/amiyatoshpurnanandam/2020/04/01/getting-ready-for-negative-interest-rates/#7b8cdabf2f87

[3] https://www.ftadviser.com/investments/2020/03/31/oil-price-crashes-to-18-year-low/

[4] https://www.theguardian.com/business/2020/mar/16/markets-hit-by-further-losses-despite-us-interest-rate-cut-willie-walsh-ba-coronavirus

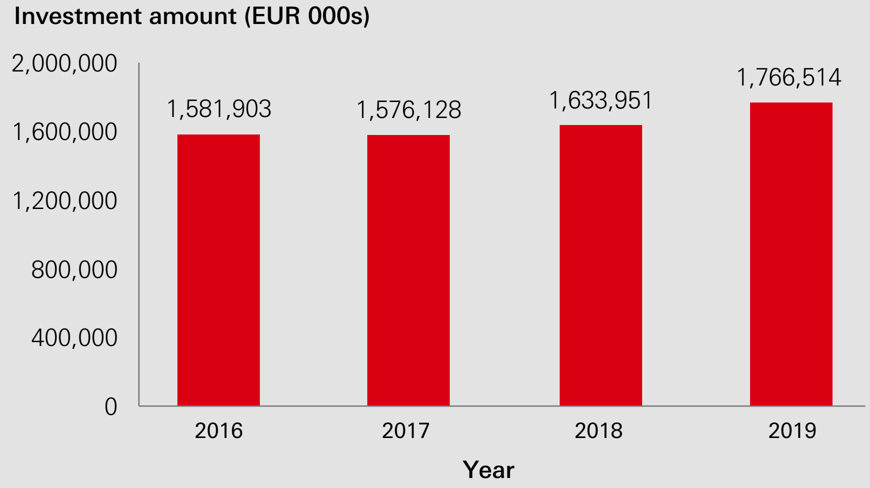
UK insurers continue to grow their private asset portfolios, but particularly their property investment portfolios year-on-year.

General insurer by private asset investment[5]



UK general insurers continue investing more and more into real assets:

UK General Issuer Real Asset Investment[5]



[5] Insurance Risk Data is a database of annual SFCR (Solvency and Financial Condition Reports) reports and associated QRT data related to Solvency II public disclosures.

With an eye towards long-term scalable and streamlined operating models that are suitable for institutional investors, top UK insurers are reviewing their property portfolios and considering restructuring into ACSs to cut complexity and the costs of ongoing operations. Rationalising the numerous investment funds holding real assets into a scalable and efficient property-centric ACS could introduce economies of scale, and position a life company for growth in an ultra-competitive environment. By making the move from, for example, a complex fund-of-fund structure holding a mix of direct real assets and indirect property to an ACS with sub-funds holding direct property, indirect property, and property centric liquidity buffers (REITs, etc.) to manage liquidity, could make focusing on performance easier and enable the externalisation of current real asset focused investment strategies.

In terms of externalisation, one key feature of ACSs is the unitisation of the fund. The fund investors trade units in the fund at quoted prices on dealing days and will alter their proportionate investment in underlying assets accordingly. This allows for a more flexible approach to investment and diversification of investment by buying into and out of sub-funds with specific asset strategies, for example. Furthermore, this approach is often favoured by external investors who are able to trade interest in illiquid assets through their interest in the ACS units themselves. In essence, an ACS can more easily externalise profitable investment strategies.

“Making the move to an ACS to manage liquidity, could make focusing on performance easier and enable the externalisation of current real asset focused investment strategies.”

The challenges and rewards of launching a property ACS

The concept of transitioning existing structures to an ACS pooling vehicle for real assets is quite simple in theory. In practice, however, there are many complexities that must be considered for any fund launch but particularly in and around property.

Accounting
Connectivity between the property accounting system and fund accounting system is of paramount importance. Furthermore, there are a number of property administration systems available, but not all are fit for purpose when considering the sheer volume of properties that might be held via an ACS property fund. The ACS manager must ensure the property administration system utilised has the functionality to cope with large volumes of granular information by way of transactions, and pass granular details to the fund accounting platform.

Items for consideration at a more granular level will include but are not limited to: pricing and dealing frequency, liquidity management, reconciliations of property management activity, cash and fund administration reporting, and cash sweeping between fund and property managers for ongoing expenses.

Tax
From a tax perspective, stamp duty implications of property seeding and potential reliefs available are complex. It should be noted that, in the UK, land taxes are devolved, meaning there are three different land regimes to consider[6]. Moreover, insurers need to question the viabilities of property transfers in terms of VAT, GST and CGT charges and reliefs as well. The taxation of property is complex and the holding of property through a TTF does not lessen that complexity. However, much work has been done in the area of taxation of property ACSs with industry bodies, fund operators, asset managers and owners. An ideal ACS tax operating model is one that establishes a regime in line with the tax authorities' rules and regulations, while giving substantially the same tax result as holding the property directly. In this way, the ACS structure achieves its dual aim of taxing investors in a like manner to the taxation of directly held properties, while enabling investors to achieve wider pooling benefits.

Other considerations
Properties don't all come in the same shape, size, colour. They also have various profiles when considering environmental impact, industrial purpose, and regulation. Properties purchased by an ACS are typically subject to due diligence via the Depositary of the ACS who will oversee the assets held in a joint nominee company structure.

Environmental, Social and Governance (ESG) criteria could also play a role in an increasingly mindful financial world. Such criteria might possibly play a role in the selection and approval of property investments not only for the ACS itself, but also the Depositary safeguarding the integrity of the ACS investors' investment and its own reputation and risk profile.

[6] Stamp Duty Land Tax: England & Northern Ireland, Land and Buildings Transaction Tax: Scotland and Land Transaction Tax: Wales

Closing

The Authorised Contractual Scheme is maturing as a fund type. Its utility is being tapped to accommodate more and more asset types and complex structures. Property and other private assets are currently at the centre of the investment dartboard. As ACSs evolve and demand for property investment grows in an ever more competitive landscape, fund managers must use everything in their arsenal to hit the bullseye. Combining the strengths inherent in asset pooling vehicles with tax efficiency and a robust property asset portfolio could give life companies the competitive advantage to create sustainable growth.

UK insurers are more frequently rationalising that this form of property asset pooling is in their interest, but they need assistance in practical terms on the mechanisms for change. The best administrators should be able to assist their clients to achieve the property ACS's full potential.

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