IPF SEMINAR: NEW UK FUND STRUCTURES - THE VIEW FROM THE MARKET

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Panel

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Summary

In the 2020 Budget speech, the government announced a wide-ranging review of the UK's funds regime. Since then, we have seen a plethora of changes including the introduction of the Long-Term Asset Fund, unlisted REITs, Qualified Asset Holding Companies and the looming Reserved Investor Fund. This seminar was a non-technical panel discussion with market participants, to reflect upon what they are looking at in practice and why. It covered two key areas:

- The new fund vehicles themselves;
- Some of the structural changes in the UK investment capital universe that are driving this change

The first point covered by the panel was the decline of defined benefit (DB) pension provision and its replacement by defined contribution (DC) provision. This process has been underway for decades but has accelerated over the last 18 months since the Liz Truss mini-budget (or, according to one of the panellists, "mini-botch-it"). The panel outlined that this has been a combination of short-term impacts of the Liability-Driven Investment (LDI) crisis that followed the mini-budget and longer-term trends as DB schemes are de-risking and looking for liquidity so that they can transfer liabilities to insurers in the bulk annuity market. They have been selling their illiquid assets including direct real estate and holdings in real estate funds. This has been a major factor in the increased volume of redemptions in open-ended real estate funds. There is a huge focus on liquidity at the moment.

Despite the impact, the decline in DB pension assets should not be exaggerated. As one panellist pointed out, although last year was a record year for DB pension transfers to insurers, at this rate it would still take twenty to thirty years to complete the process. The UK life insurers do not have the capacity to process all the potential transfers at once. A key requirement for insurers acquiring the liabilities is that they can match them directly against long-term assets for solvency capital purposes under the Solvency II Matching Adjustment rules. The Solvency II rules which govern life insurance companies are changing in the UK as we diverge from Europe. One specific aspect is to Matching Adjustment rules, which is to be extended to allow the inclusion of assets with income flows that are “highly predictable” rather than “fixed”. A consultation on this by the Prudential Regulation Authority (PRA) closed on 5th January. The changes should allow a wider range of real estate assets to be included. Unfortunately, the conditions being proposed by the PRA make it potentially sufficiently unappealing that nobody will use it in practice. One panellist also noted that the PRA currently take the view that only direct investment is eligible as they believe that indirect investment does not give the investor sufficient control to treat the returns as “predictable”.

Reform of DC pension provision, which was announced by George Osborne in 2014 has now finally come into effect. This is intended, amongst other things, to increase investment in illiquid assets by DC schemes. It was noted in the discussion that many of DC schemes had historically invested in real estate through daily-traded property funds. The problems of this part of the market have been well-publicised, with many of these funds closing in recent years. This raises the question of whether this money will come back into real estate and other illiquid assets. There was some optimism that the pension reforms requiring disclosure of investment asset classes and the “Value For Money” requirements will encourage greater investment in better performing but more expensive to manage illiquid assets. However, this was tempered by the fact that majority of investment comes through master trusts. Both the government and the panel see the master trusts becoming even more dominant, and they are very focussed on cost. This is likely to remain the case, which will favour the larger managers who already have scale.

George Osborne’s 2014 announcements also included the pooling of the Local Government Pension Scheme (LGPS) funds, which is now actually starting to happen in practice for real estate as an asset class a decade later. Although the LGPS is now in net outflow, it remains a major investor in real estate and other illiquid assets. Following pooling, there is a shift towards more direct investment, but the LGPS funds are still also major indirect investors.

Foreign investment in UK real estate will also remain extremely important, although it was noted that the mini-budget fiasco had not helped the UK’s international reputation.

The panel then moved on to discuss three of the new UK fund structures, the Long-Term Asset Fund (LTAF), structures using a private or unlisted Real Estate Investment Trust (REIT) and structures using a Qualifying Asset Holding Company (QHAC). The legislation for the LTAF came into effect in November 2022, with the first two LTAFs getting FCA approval in the spring of last year. The REIT and QHAC

changes were announced in the 2022 Spring Statement and came into effect on 1st April 2022. A large number of each have been set up since then.

The LTAF is specifically designed for DC pension investment, but is also eligible to certain retail investors. Interest to date has mainly been in gaining access to the DC market, although even for this major obstacles remain. The LTAF is required to have a minimum 90 day notice period for redemptions, which are not permitted to be more frequently than monthly. In practice redemptions are more likely to be quarterly. A move away from the daily liquidity to which DC schemes are accustomed was felt to create challenges, culturally and operationally. These may be resolved in time as structural solutions are figured out.

Cost is likely to be an issue. Despite the regulatory imperative to focus on value for money rather than costs in isolation, DC schemes and master trusts are very focussed on cost. Many DC schemes are small and do not have the benefits of scale. One particular issue for LTAFs is that they are new and it is perceived as difficult to demonstrate any track record. It is therefore difficult for schemes and their advisers to differentiate between providers other than on the basis of cost.

All of this means that there is a big question mark over how much DC money the LTAFs currently being set up will raise in practice. There appears to be no real evidence at this stage. The other big question mark is if money is raised, how much of it will be allocated to real estate as an asset class. The LTAF is intended to invest in illiquid assets more generally and investment in infrastructure, particularly associated with the green transition, is high on the agenda at the moment. There is also an interesting debate as to whether the LTAF is best suited to direct investment or indirect as a fund-of-funds.

The second vehicle discussed was the private REIT. Following the 2022 changes, a REIT no longer needs to be listed to qualify for the regime, provided that it is owned at least 70% by institutional investors. A fund that meets certain tests to determine that it is a genuine fund is treated as an institutional investor, so a private REIT owned by, for example, a limited partnership makes an excellent choice for investing in direct property. The increase in the UK corporation tax rate from 19% to 25% has added impetus to this.

It was noted that the REIT conditions, particularly the income distribution condition, need to be met on an ongoing basis but this was not considered a major challenge.

There was a discussion as to the benefits of converting existing funds, such as offshore unit trusts, to structures with private REITs. Many investors do not suffer any particular disadvantage from existing funds structures, which raises the question as to who should carry the costs of conversion? Although conversion may improve liquidity in the fund units, this is difficult, if not impossible to prove and quantify ahead of conversion. The view was expressed that the manager should incur at least a proportion of the cost, although this will depend upon the circumstances.

Following a question from the audience, there was a brief discussion of listed REITs. As these are currently mostly trading at a significant discount to Net Asset Value and the market is currently awful for an IPO, this was considered somewhat academic for

a new vehicle now. A private REIT is a potential stepping-stone to a listed REIT in the future when the market is more buoyant.

The QHAC structure with a limited partnership is very similar to the private REIT structure, but for assets other than direct property. As with the private REIT, it owned at least 70% by qualifying investors, which includes a fund that meets certain tests to determine that it is a genuine fund. A limited partnership holding a QAHC is therefore an excellent vehicle for investing in assets other than direct property. It was thought that between 250 and 300 had already been set up, with possibly the majority as credit funds. In the real estate context, it was thought that almost all QAHCs are being used for real estate debt funds.

The session finished with some brief comments on the Reserved Investor Fund (RIF), whose arrival is imminent. The RIF will be an unauthorised co-ownership contractual scheme for professional investors and high net worth / sophisticated investors. In earlier stages of the consultations around its introduction, it was known as the Professional Investor Fund (PIF). It was noted that, as with the other new fund vehicles covered in the seminar, the proposals have been through extensive public and industry body consultation prior to launch to ensure that the final legislation is fit for purpose.

In the time available, the panel had only been able to scratch the surface of these topics and there was strong support for a follow-up event on the LTAF.

John Forbes
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