Ammonites Revisited

A brief update on the 2010 paper "Ammonites, extinction events and the real estate funds industry"

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Ammonites, extinction events and the real estate funds industry

The paper "Ammonites, extinction events and the real estate funds industry" was originally produced in the autumn of 2010 as a write-up of a presentation at that year's PwC European Real Estate Client conference by John Forbes. The conference presentation and the paper reflected upon the regulatory and other pressures facing the real estate industry in the aftermath of the Lehman collapse, as well as providing some predictions as to how this might unfold over the two years to the autumn of 2012. Two years later, four years after the collapse of Lehman and at the time predicted in the original report as the point of maximum pressure on the real estate investment management industry, John wrote an update of the report. Now another four years on, during which time John has left PwC and set up John Forbes Consulting LLP, we have produced another update.

The original conference presentation opened with an image of an ammonite.

Photo: Jurassic ammonite, found in Charmouth, Dorset. Photo from www.discoveringfossils.co.uk

Contents

The palaeontology

Millions of years ago ammonites filled our oceans, with species from a few millimetres across to huge examples over three metres in diameter.

251 million years ago there occurred what is known to scientists as the Permian–Triassic extinction event, or more evocatively as 'the great dying'. This was the Earth's most comprehensive mass extinction and at a time when the majority of life on this planet existed in the ocean, the event killed over 95% of all marine species, including over 90% of ammonite species. However, in the period following the extinction event, new species evolved, including a wide variety of new ammonites. Diversity returned.

About 205 million years ago, the planet suffered another mass extinction, the Triassic–Jurassic extinction event. In the seas over 90% of ammonite species again became extinct. Once again after the extinction, news species evolved. The extinction left the dinosaurs as the dominant land animals and a huge variety evolved. In the oceans, new ammonite species evolved to fill the gap left by the extinction.

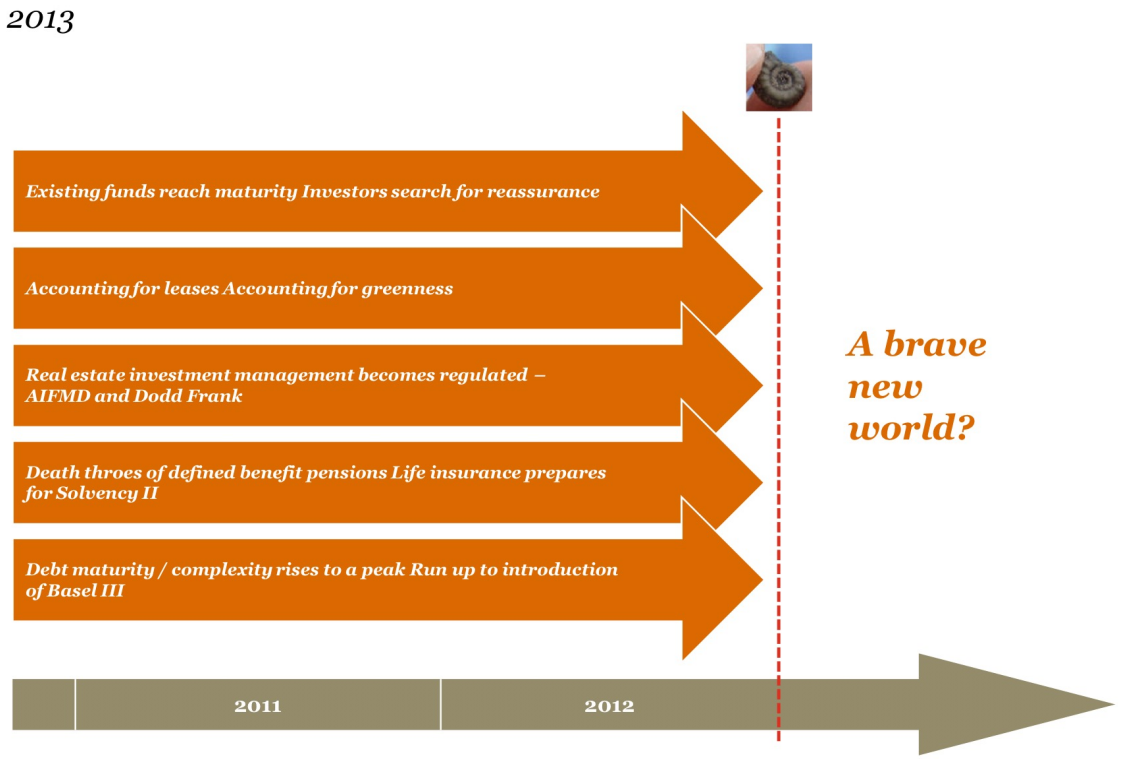
Then about 65 million years ago the planet suffered the Cretaceous–Tertiary extinction event or K-T extinction. About 75% of species became extinct. Although statistically not the most comprehensive extinction event, it is undoubtedly the most famous as it resulted in the end of the dinosaurs. Mammals and birds emerged as the dominant land vertebrates in the age of new life. The K-T extinction event also finished off the ammonites.

As one might expect, considerable scientific research effort has gone into investigating the circumstances giving rise to mass extinction events. In 2008, Nan Crystal Arens and Ian West published Press-pulse: a general theory of mass extinction? This proposed a model which suggests that mass extinctions generally require two types of cause: long-term pressure on the eco-system which they referred to as 'press' and a sudden dramatic event or 'pulse' at the end of the period of pressure. Their statistical analysis of marine extinction rates suggested that neither long-term pressure alone nor a catastrophe alone was sufficient to cause a significant increase in the extinction rate.

The real estate industry

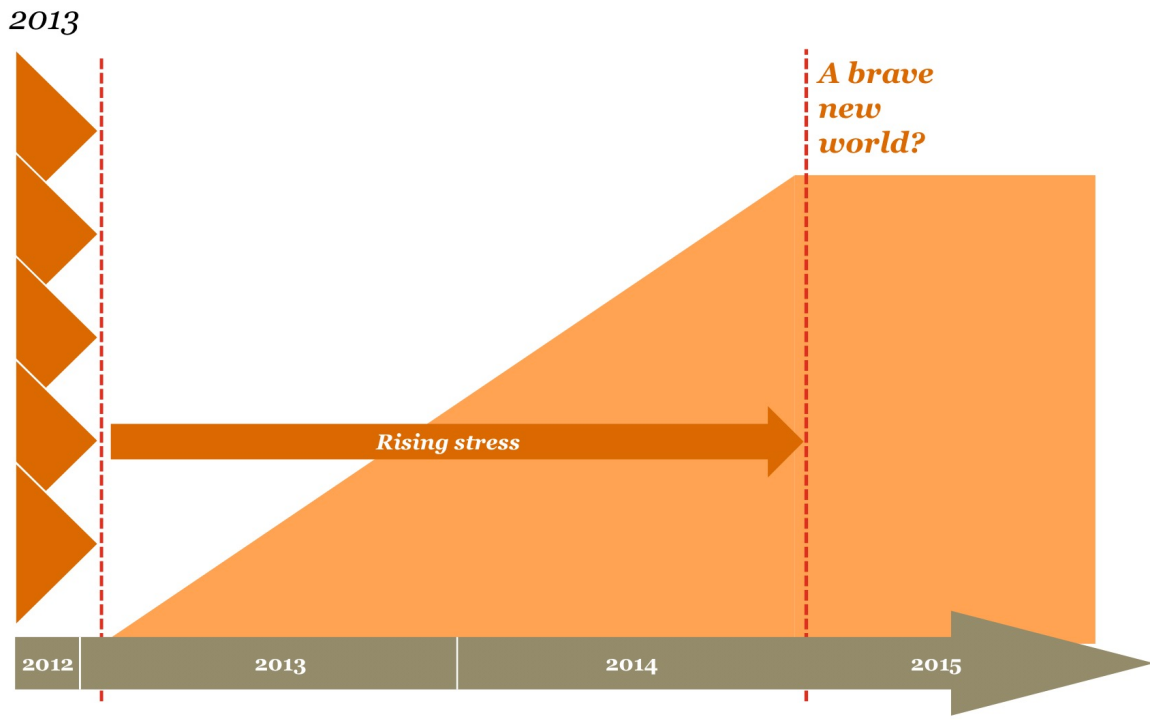
What is the relevance of this to the real estate investment management industry? What if press-pulse theory is as applicable to real estate fund managers as it was to ammonites? For the real estate funds industry in the United States and the United Kingdom, at the time of this original paper in 2010 a period of pressure had continued largely uninterrupted to date since the liquidity crisis in the summer of 2007. This pressure became global in the aftermath of the collapse of Lehman Brothers and the bail-out of AIG over the weekend of 13th and 14th September 2008. The central message of the original paper was that the pressure from the weak economic situation and the aftermath of the financial crisis would last until at least 2013, and that a raft of regulatory changes all scheduled to come into effect on the same day, 1st January 2013, might provide the pulse that pushed real estate investment managers into extinction.

We set out the proposed changes that were the source of such concern in the following diagram:



By the time of our update in 2012 it had already become apparent that these major regulatory and other changes were in many cases being delayed so the impact was expected to be spread over 2013 and 2014 rather than arriving in one overwhelming blow on 1st January 2013.

Our updated diagram now looked like this:



What were we so worried about in 2010, and what has happened since?

Debt

At the time this paper was originally published in the autumn of 2010, there had already been considerable discussion of the looming debt bubble. This had focused on the volume of debt to be refinanced and whether or not there was sufficient capital to fill the void. There was also concern that it was not only the volume, but also the complexity that was set to increase as the proportion of the debt represented by syndicated loans and Commercial Mortgage Backed Securities (CMBS) increases significantly. With this, the process of negotiation becomes more complex and the eventual outcome in each case less certain. The other huge concern was the impact of regulatory change, in particular the pressure on the banks as they cope with the introduction of Basel III. It was clear even then that the banks would need either to raise new capital or to reduce the volume and risk profile of their loan assets.

Basel III is a global, regulatory framework governing bank capital adequacy, stress testing and liquidity. Within the European Union, it is implemented by the Capital Requirements Directive IV (CRD IV). At the time of the original paper, the capital requirement element of Basel III was due to be implemented from 2013 to 2015. Other elements were due to be phased in by 2018. By the time CRD IV had been implemented, the timetable had moved to a phased introduction from 1st January 2014 to 2019. Key elements of the capital buffer requirements started coming into phased effect from 1st January 2016.

Within the European Union, The European Banking Authority (EBA) is responsible for monitoring compliance with CRD IV. The EBA published the result of its most recent monitoring exercise, based on results to 31st December 2015, on 13th September 2016. This showed a continuing improvement in banks' capital adequacy, a process that had been ongoing since mid 2011. It is fair to say that the results were greeted with some scepticism by a number of commentators who suggested that the picture was not as benign as it appeared, particularly in respect of the systemic problems faced by Italian lenders.

The phased introduction of Basel III has allowed time for new entrants to come into the market as lenders, particularly insurers and debt funds. It has also allowed significant recapitalisation with equity such that leverage levels are much less of an issue than they were in 2008.

The regulatory environment for the banks continues to develop. The Basel Committee is working on what it regards as refinements to the implementation of the Basel III capital requirements to be finalised by the end of 2016. However, the changes are regarded as so substantial by the banking industry, they are almost universally referred to as Basel IV. Pressure from the industry may result in some compromise, but the pressure on the banks will remain.

In the UK, the period post 2010 had seen a significant period of recapitalisation. An influx of new equity from less heavily geared buyers, coupled with a rising market significantly reduced loan to value levels. According to the six monthly De Montfort University Real Estate Lending report, in the first half of 2015 overall UK real estate lending fell to its lowest level since 2005. Debt levels moved upwards again in the second half of 2015, driven by new types of lender, particularly insurance companies. The overall rise in lending levels continued into 2016, although in the first half of 2016 this was as a result of increased lending by banks and building societies.

Significantly, loan to value levels are not at anything like pre-crisis levels. According to the de Montfort study for mid 2016, nearly 90% of loans are now at an LTV of 70% or less.

A real estate investment environment with more equity, less risky lending and long-term benign interest rates means that the concerns that we had in 2010 regarding the looming debt bubble are no longer a concern, at least in the UK.

Provision for old age

Provision for old age creates two of the major sources of capital for real estate investment, pension funds and life insurance companies. Both face significant changes.

The impact of demographic change will affect pension provision as the developed world ages and a new middle class in the emerging economies looks to provide for its old age. Across the globe there is a continuing switch from defined benefit to defined contribution pension provision. In the UK, employers continue to close or reduce defined benefit provision, and most see defined contribution as their prevalent workplace pension provision in future. This represents a significant challenge for the real estate industry as defined benefit plans have been the more significant investors in real estate as an asset class. For real estate to continue to be a significant asset class for pension provision, the real estate industry needs to create product to appeal to defined contribution plans and defined benefit plans in run-off.

At the time this paper was originally published in 2010, we identified the looming threat for the real estate industry of the introduction of Solvency II, a major overhaul of the Directive regulating insurance companies in the EU. Life insurance companies were, and indeed still are, major investors in real estate as an asset class. In the two years following the publication of our paper, the Directive became a major source of concern for the real estate industry. In particular, the Pillar I, Solvency Capital Requirement market shock of 25% was felt to make real estate as an asset class unattractive relative to bonds.

In April 2011, the Investment Property Databank (IPD) published a study focusing specifically upon real estate. (https://www.inrev.org/attachments/article/184/IPD_Solvency_II_Review_20110415.pdf) This study was funded by a consortium of seven key real estate trade bodies led by INREV. John Forbes was a member of the Solvency II Working Party, of the Investment Property Forum, one of the participating organisations. The study identified a number of areas of concern, but specifically in respect of the property shock, the report suggested that 15% was a more accurate reflection of pan-European volatility than the 25% suggested by the regulator.

The IPD subsequently updated its analysis (https://www.inrev.org/attachments/article/184/IPD_Solvency_II_Update_20110902.pdf) continuing to support the view that the currently proposed property shock is excessive. Despite the best efforts of INREV, the IPF and other industry bodies rallying around the effort, the EU Commission was not swayed by the lobbying and that the 25% market shock remained.

In practice, many large insurers have taken the opportunity to get approval from their local country regulator to use their own models rather than to use the standard model.

The introduction of Solvency II subsequently become embroiled in delay and confusion. It was originally intended that Solvency II would be introduced with effect from 1st January 2013. This was delayed under a "quick-fix Directive" until 1st January 2014. On 2 October 2013 the European Commission published proposals for another "second and final quick-fix" Directive changing the application date of Solvency II to 1 January 2016. Despite continuing muddle and against the expectations of many, including us, Solvency II came into effect on 1st January 2016.

At the time of our original paper, it was unclear how indirect investment in real estate would be treated. This was subsequently clarified and investment in funds is now generally dealt with on a look-through basis. This has implications for the amount of data that will need to be provided to investors for them to use in their solvency models.

The Pillar II and Pillar III requirements of Solvency II mean that insurers will be paying much greater attention to risk management and the controls environment of managers through whom they invest.

A further significant development in the period immediately after the publication of our original paper was the proposed extension of Solvency II type rules to occupational pension schemes. In April 2011 the European Commission asked the EU insurance regulator EIOPA for advice on the EU wide legislative framework for occupational pension schemes. The publication of EIOPA Final Advice in February 2012 followed a period of consultation, the final stage of which ran until 2 January 2012 and was commented upon by 170 stakeholders from 14 Member States and 20 European and international organisations. These proposals largely mirrored Solvency II, including the capital requirements element. However, since then the capital adequacy rules have been delayed, probably indefinitely, with only the Pillar II and Pillar III elements remaining.

What does this all mean?

In the short term there will be challenges for the real estate investment management industry in dealing with the immediate reporting and other requirements of the Directives. In the medium term, for funds looking to attract life insurance investors, there will be product development opportunities as insurers are attracted to investment structures and products that give rise to lower Solvency II capital requirements.

In the longer term, the requirements of Solvency II (and possibly IORP II if it does end up with some form of capital adequacy regime) will accelerate the decline in defined benefit retirement provisions. This was already a process that was well underway. To date the real estate investment management industry has struggled to access the defined contribution retirement market.

Both Solvency II and IORP II are regimes set by EU Directives. For those in the UK, their ongoing application is therefore clouded in uncertainty following the UK's EU referendum vote. This is discussed later in this paper.

You can read more about Solvency II and IORP on our website here: http://www.johnforbesconsulting.co.uk/solvencyii/

In the UK, the Local Government Pension Scheme (LGPS) has been a mainstay of indirect real estate investment. We have commented in recent months in our newsletters on the proposals to consolidate the existing 89 Local Government Pension Scheme funds in England and Wales into a much smaller number of funds. In July, 8 pools submitted detailed proposals, information on which can be found on the website of The Local Government Pension Scheme Advisory Board here: http://www.lgpsboard.org/index.php/structure-reform/investment-pooling-2015

We will be providing updates in our newsletters over the coming months.

Real estate investment management becomes regulated

When the original paper was published in 2010, two major pieces of fund management regulation were imminent, the Alternative Investment Fund Managers' Directive (AIFMD) in Europe and the regulation for the Dodd-Frank Wall Street Reform and Consumer Protection Act in the US. The AIFMD was passed by the EU Parliament on 11 November 2010 and the Dodd-Frank Act had already been enacted in July 2010. In both cases, the detailed regulation was awaited at the time of our original paper. The rules for both are complex and have added materially to the regulatory burden of managers.

AIFMD

22 July 2013 was the implementation date for the AIFMD across Europe, although some countries missed the original deadline for authorisation. Managers of investment funds other than UCITs funds had to be authorised by their local regulator and comply with the copious requirements of the directive in respect of:

i) Regulatory capital;
ii) Disclosure and transparency;
iii) Policies and procedures;
iv) Remuneration;
v) Appointment of a depository.

Our initial concerns about the volume of work needed for day one, were mitigated by a transition period and grandfathering provisions. Existing managers of funds had a one-year transition period to become compliant. There were also grandfathering provisions that exempted from authorisation managers who managed only closed ended funds

i) That made no additional investments after 22nd July 2013; or
ii) For which subscription period closed before 22 July 2011 and the fund will terminate before 22 July 2016.

Unfortunately, the advantages of AIFMD have also been less dramatic than originally anticipated. Whilst the slower and more patchy implementation mitigated the initial burden, it has also undermined the benefits of passporting as individual country implementation has not been uniform. There is, however, grounds for optimism. On 2nd June 2016, as part of progress on the European Union Capital Markets Union (CMU), the European Commission published a consultation to obtain feedback on how cross-border distribution of funds could be improved. This includes funds under AIFMD. This consultation sought feedback in the following areas:

a) *Marketing restrictions*: EU funds marketed cross-border are usually required

to comply with national requirements set by host Member States, which differ across the EU. Significant costs can be incurred in researching each EU Member State's financial promotion and consumer protection regime, and providing appropriate materials on an on-going basis.

b) *Distribution costs and regulatory fees*: EU funds can be subject to regulatory fees imposed by home and host Member States that vary significantly in both scale and how they are calculated. The costs themselves and the need to research them are reported as acting as a barrier to cross-border distribution.

c) *Administrative arrangements*: Where EU funds using the marketing passport are sold to retail investors, host Member States sometimes introduce special administrative arrangements intended to make it easier for investors to subscribe, redeem and receive related payments from those funds, as well as receive tailored information to support them in doing so. These are an additional burden that may not always justified by the value added for local investors.

d) *Distribution networks*: With increasing use of online platforms to distribute funds, we want to understand the barriers that hinder the use of online and direct distribution across borders.

e) *Notification processes*: Where funds are marketed on a cross-border basis and there is a need for documentation to be updated or modified, asset managers are required to give written notice to the competent authority of the host Member State. This can add cost and time to the process.

f) *Taxation*: differential tax treatments can sometimes create barriers to cross border business. Feedback is sought on how best to promote best practice and avoid discriminatory tax treatment.

The consultation closed on 9th October 2016 and the results are awaited. From a UK perspective, it is entirely possible that following the referendum vote UK managers will cease to benefit from the passporting regime just as the current failings are resolved.

There are other open areas that have not yet been fully resolved. These include remuneration practice and third country access. These are discussed below.

Remuneration practice

The original remuneration practice guidance was published by The European Securities and Markets Authority (ESMA) in July 2013. Following various pronouncements and updates, ESMA's final report on remuneration practice was published in March 2016.

It can be found here: https://www.esma.europa.eu/sites/default/files/library/2016-411_final_report_on_guidelines_on_sound_remuneration_policies_under_the_ucits_directive_and_aifmd.pdf

The final, amended, guidelines were published by ESMA on 14th October 2016 and can be found here: https://www.esma.europa.eu/document/guidelines-sound-remuneration-policies-under-aifmd-2

Third country access

The introduction of a third country passport was set out in the Directive for AIFMD in 2011. This would allow non EU fund managers to opt in to EU compliance to market funds to institutional investors in the EU. ESMA has been considering non EU fund manager regulatory regimes that might be sufficiently analogous to the AIFMD requirements that managers from those countries might be able to opt into the regime. An initial, positive, report from ESMA regarding a number of non EU countries was published in July 2016. The timetable, which has already slipped, is exceedingly vague, the interaction with an process for the removal of the existing National Private Placement Regimes (NPPR) is uncertain and the practicalities of dealing with the 2011 Directive retirements in this area, which are in some cases impractical in practice is a bit of a mystery. The timing and detail of what will be introduced is therefore extremely uncertain. This must be a concern for any UK managers who want to rely on third country passporting rather than setting up operations in an EU country to access the market post Brexit. This is discussed further later in this report.

Dodd Frank

The Dodd–Frank Wall Street Reform and Consumer Protection Act is much broader in its application than AIFMD, being a comprehensive financial services regulation package. Our key concern in 2010 was the potential extra-territorial aspects - how far would it affect non-US fund managers.

Investment advisers are regulated in the United States under the U.S. Investment Advisers Act of 1940. Historically, many non-US advisers were able to rely on the private adviser exemption to avoid registering with the US Securities and Exchange Commission (SEC). This was removed with effect from July 21, 2011 and replaced by a more limited exemption. As a result, non-US advisers with US investors in their funds, manage funds in the US, or have a physical presence in the US are potentially subject to registration in the US.

The new, more limited foreign private adviser exemption applies to an investment adviser or fund manager that:

- has no place of business in the US;

- has fewer than 15 US clients;
- has less than $25 million in assets under management attributable to US clients:
- and neither holds itself out to the US public as an investment adviser, nor acts as an investment adviser to any investment company.

For those that do not qualify for foreign private adviser exemption, there is a further private fund adviser exemption. Non-US firms are exempt from registration if:

- the firm has no client that is a US person, except for one or more private funds; and
- all assets managed by the firm from a place of business in the US are solely attributable to private fund assets, the total value of which is less than $150 million.

Overall impact

Regulatory compliance has become a significant cost for real estate investment managers and as we anticipated in 2010, a major barrier to new entrants to the market. Service providers have developed outsourced options that have created new ways of addressing the challenges.

Changing tenant behaviour

Much has been written about the commercial and technological advances that are changing tenants' requirements for physical property. Our comments in 2010, focussed on two areas of reporting requirements that we thought would have an impact:

- Accounting changes to the treatment of leases;
- Sustainability reporting.

These are discussed below.

Accounting changes to the treatment of leases

At the time that this paper was originally published in 2010, the IASB and FASB had proposed a new approach to lease accounting that would significantly change the way companies across the world account for leases. The proposed model would eliminate off-balance sheet accounting. All assets currently leased under operating leases would be brought onto the balance sheet, removing the distinction between finance and operating leases. This will dramatically change the balance sheets of major property occupiers. The results of a PwC impact survey by sector at the time showed an average increase in reported interest bearing debt for all companies of nearly 60% and for retailers, the most severely impacted sector, of over 200%. This was felt likely to encourage acceleration in the existing trend towards shorter lease lengths as well as other changes to lease terms. The exposure draft at the time did not propose an effective date. We anticipated in 2010 the final standard to have an effective date no earlier than 2012.

After a much delayed process, The International Accounting Standards Board (IASB) finally issued the standard to effect the changes, IFRS 16 “Leases”, in January 2016. It is effective from 1 January 2019.

Although the impact in terms of the accounting changes is for the tenants rather than the landlord, the knock on effect will be to increase the pressure for shorter and more flexible leases. This is significant in an environment where life insurance and pension investors are looking for long leases with guaranteed incomes to match against long-term liabilities.

Sustainability reporting

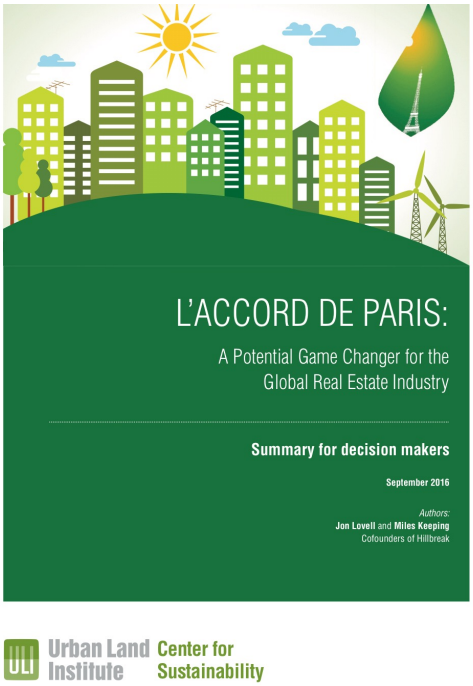
It was already apparent in 2010 that another driver of changing tenant behaviour would be the developing focus on sustainability. A broad range of stakeholders, including regulators and investors, are ensuring that sustainability will be

something in future that requires measurement and performance reporting, well beyond broad mission statements.

This has undoubtedly been the case.

The built environment is a huge contributor to global greenhouse gas emissions, being responsible for between a third and a half depending upon the analysis.

Matters took a huge step forward in late 2015, when the 21st annual Conference of the Parties (COP-21) to the United Nations Framework Convention on Climate Change took place in Paris. 195 countries reached an agreement to combat climate change by accelerating the transition to a near-zero carbon global economy. The effects of the agreement will be unprecedented in both breadth and depth. In terms of impact for the real estate industry, we have not provided an analysis here as a summary that we could not possibly match has been produced by the Urban Land Institute. It can be found here: http://uk.uli.org/councils-and-forums/sustainability-council/cop21-potential-game-changer/



From a real estate investment perspective, a major change since our original report has been the development of the Global Real Estate Sustainability Benchmark (GRESB). This had been founded prior to the publication of our original report, but at that stage had achieved little traction. Although there is not universal agreement in the industry of some of the detail of GRESB, there is little doubt that it has become an important measure for both managers and investors.

In addition to direct property, GRESB was expanded in 2015 to include real estate debt and in 2016 to include infrastructure.

The GRESB website can be found here: https://www.gresb.com

Investor behaviour

At the time of our original report, we were expecting an increase in funds coming to a natural end, particularly in the second half of 2012. At the same time a number of closed funds were reaching the end of their commitment periods. All of this meant that some fund managers were facing pressure to raise new funds to ensure that they had a continuing revenue stream. Many open-ended funds had also faced a period of significant challenge during the financial crisis. In our original report, we anticipated that as they sought to raise new funds, managers would face some challenges in dealing with an investor base that had become significantly more demanding as a reaction to events over the preceding three years.

The immediate crisis for closed-ended funds was mitigated by investors in many funds agreeing to extensions that resulted in a spreading of the winding up. Major investor concerns remained however.

Unlisted funds - lessons from the crisis

John Forbes was the author of a major report by PwC for the Association of Real Estate Funds, "Unlisted funds - lessons from the crisis", published in January 2012. This report identified some immediate areas for improvement in behaviour and some longer term drivers for product development.

In the case of the former, transparency between fund managers and investors is crucial to the continued prosperity of the real estate fund management industry.

In 2012, most fund managers felt that they had taken significant steps to improve the quality and quantity of communication with investors, although investors felt that there could be further improvement in quality. There were specific areas where greater transparency was felt to be essential. For open-ended funds, the detailed workings of the timing and pricing of subscription and redemption are so fundamental to the model that a lack of transparency and lack of understanding among investors has the potential to cause lasting damage. Significant steps have been taken in this key area, and the basis of underlying valuation have also been the subject of further work by AREF and others.

There was also a general perception that closed-ended funds are less transparent than open-ended funds. As investors' capital is tied up for a longer period, this is a significant area of concern and needed to be addressed. Under pressure from investors, significant steps have been made in this area.

Open-ended funds

One of the most dramatic impacts of the crisis on real estate was the redemption crisis faced by the open ended funds. In the aftermath, investors had many questions regarding the behaviour of managers:

- How well prepared for the downturn and liquidity crisis was the manager?
  - How effectively had the manager controlled inflows in the run up to the crisis?
  - Had they anticipated an increase in redemptions and built up cash reserves within the fund to put it in a stronger position to cope with outflows?
  - How liquid were the fund's underlying assets?

- How well did the manager cope with the decision as to whether or not to suspend redemptions?
  - Did the manager implement a decision-making process that ensured the engagement of a broad range of stakeholders?
  - How good was communication?
  - Did the investors agree with the decision taken?

- Did the manager learn from the experience and are the changes introduced continuing?

Since the report was published, there has been an increasing acceptance by institutional investors of more limited liquidity in open-ended funds to reduce volatility. Many open-ended funds have lengthened the time available to meet redemption requests and made other changes to redemption queuing arrangements. It has also been common for managers to introduce more dramatic arrangements to deal with high levels of redemptions, for example by introducing fixed gates on the volume of redemptions to be met in a quarter or a year. This also has potential drawbacks so there is also interest in more flexible arrangements with the introduction of independent supervision to take some of the subjective elements out of the hands of the manager.

You can find the report and associated materials on our website here: http://www.johnforbesconsulting.co.uk/aref-4-year-blog/

In the UK, the changes in liquidity arrangements for open-ended funds with only institutional investors were not matched in funds with retail investors. The EU

referendum result triggered a redemption crisis in many of these daily traded funds with retail investors.

AREF has announced that John has been appointed to undertake an independent review of the impact of the referendum result on real estate funds and to evaluate whether any improvements could be made to deal with market shocks in the future. The primary focus of the research will be to assess the impact on clients following the referendum, but it will also take a view of the whole market including fund distributors, managers, valuers and other service providers. It will also look to identify areas where market participants believe there might be aspects of manager or investor behaviour for which 'best practice' might be established by AREF itself or the regulator. The research will be published in the first quarter of 2017.

Closed-ended funds

Although it has taken slightly longer, the treatment of closed-ended funds as they approach the end of life has also now been addressed. INREV, AREF and the Investment Property Forum (IPF) set up the End of Life Project which aimed to provide advice on best practice relating to the end of life period for closed-ended real estate funds.

After an extensive interview process and a consultation process, the final report was published in September 2016.

You can download the report here:
http://www.end-of-fund-life-group.org.uk/wp-content/uploads/2015/10/End-of-Fund-Life-Report_Final-DocumentV7.pdf

and find other information on the project here:
http://www.end-of-fund-life-group.org.uk

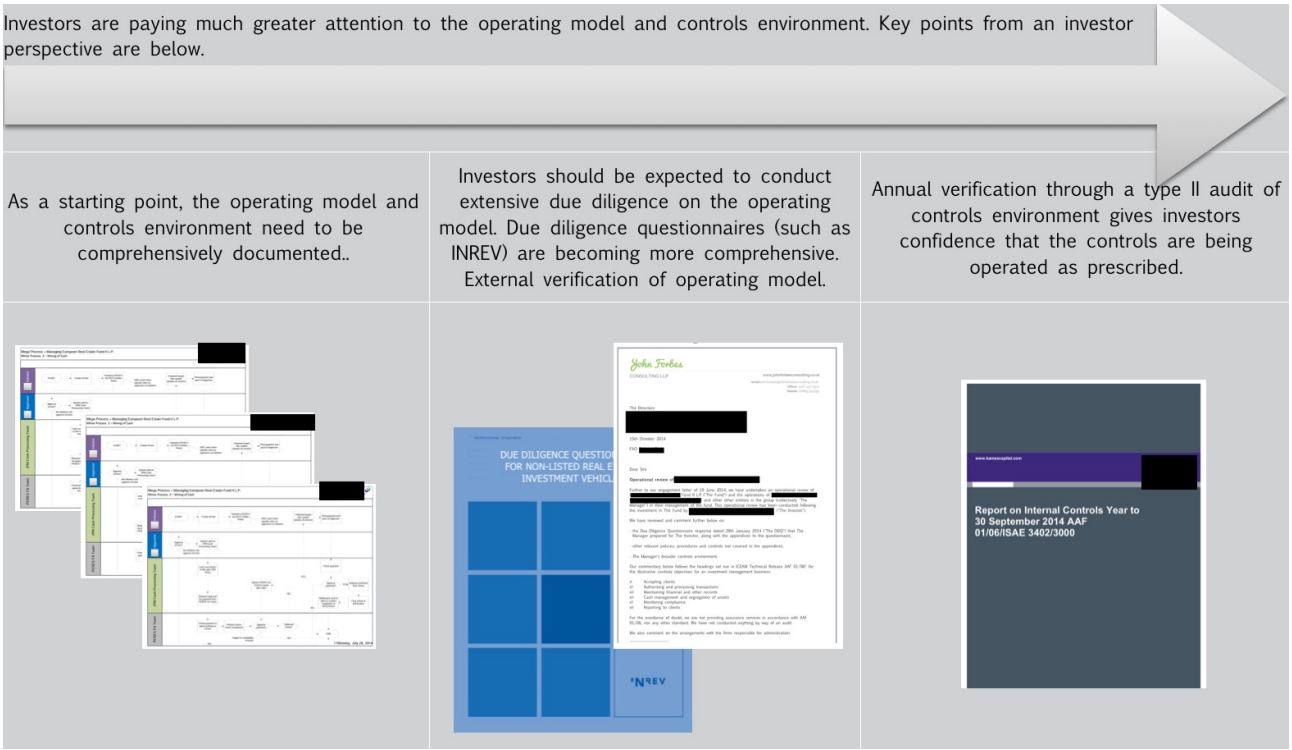
John was a member of the project team and chaired the panel discussion at the launch event.

Due diligence, costs and fees

We commented in 2010 that investors had become much more demanding in terms of upfront due diligence and ongoing reporting. At the time of our original report, INREV had just updated its standard due diligence questionnaire to give a much greater focus on operational matters. This has continued to develop. Both investor demands and regulatory requirements pushing in the same direction, resulting in increasing costs. We also commented in 2010 on the downward pressure on fees, leaving many fund managers caught in a difficult trap with rising costs and declining fees.

The real estate market has undergone a boom since then, particularly in the UK. This has boosted inflows into funds and fees for managers. As a result, many managers have been sheltered from the impact of rising costs.

The pressures from investor demands and regulatory compliance remain undiminished. In the case of the former, investors are looking at a process, with verification, that continues through the life of the fund.



At the time of our original paper, we noted that fund managers were also starting to recognise the benefits of third party verification, in particular in two key areas:

- 'Confidence in the performance track record'

- 'Regular assurance over the design and operational effectiveness of controls', achieved through verification under two standards, at that time SAS 70 from the United States and AAF 01/06 from the United Kingdom, which replaced FRAG 21 in 2006. Since then the US SAS 70 has been replaced by ISAE 3402.

As independent assurance of the controls environment has gained traction with fund managers, it has had a knock-on effect on service providers. Managers outsourcing activities increasingly need to demonstrate that an effective controls environment operates through the whole chain.

Independent assurance also has benefits in dealing with regulatory compliance.

And one point on which we were specularly wrong

We confidently predicted that the era of the monster closed-ended fund was over that fund sizes would be smaller in the future. Blackstone and others have clearly proved us wrong.

Some big tax changes we did not predict in 2010

The OECD launched an Action Plan to tackle international tax avoidance at the request of the G20 Finance Ministers in July 2013. This will have a major impact on cross-border real estate investors. At the time of the launch, many commentators were very sceptical about the ability of the OECD to deliver on this. We said at the time that we thought that this hugely underestimated the determination to move this forward. The BEPS Action Plan provided for 15 actions scheduled to be finalised in three phases: September 2014, September 2015 and December 2015. The OECD published the first seven elements of its Action Plan in September 2014. All 15 Action plans in updated form were published by the OECD on 5th October 2015 and were adopted by the G20 Finance Ministers Meeting in Lima on 9th October 2015. Even without the attention from the Panama revelations, the BEPS initiative had very significant momentum.

The most innovative step was through Action Plan 15, "Developing a Multilateral Instrument". This is possibly the most significant aspect of the whole BEPS initiative. One of the major challenges facing the BEPS project is the volume of work that would be required to implement changes to the more than 3,000 bilateral double tax treaties in existence. The original Action Plan 15 paper considered the practicality of addressing this through a single multi-lateral instrument to which countries could sign up. It is therefore designed to accelerate the implementation of the proposals set out in the other actions rather than to introduce new measures. It is likely to mean that many of the measures would be introduced earlier than would otherwise be the case. Considerable progress has been made. An ad hoc group to develop the multilateral instrument was approved by the OECD Committee on Fiscal Affairs and endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015.

The Group, which is chaired by Mike Williams, Director of Business and International Tax with the UK Treasury, began its work in May 2015 with the aim to conclude this and open the multilateral instrument for signature by 31 December 2016.

Astonishingly there are fund managers who are blissfully unaware of the whole BEPS initiative.

More details on the BEPS initiative and what it means for the real estate investment management industry can be found here: http://www.johnforbesconsulting.co.uk/beps/

Within the EU, implementation of BEPS is being dealt with on a pan-EU level by Directive. On 21 June 2016, the Council agreed on a draft directive addressing tax avoidance practices perceived to be commonly used by large companies.

The directive is part of a January 2016 package of Commission proposals to strengthen rules against corporate tax avoidance. The package builds on the 2015 OECD BEPS recommendations. The directive addresses situations where corporate groups take advantage of disparities between national tax systems in order to reduce their overall tax liability.

The draft directive lays down anti-tax-avoidance rules in five specific fields:

Interest limitation rules. Multinational groups may finance group entities in high-tax jurisdictions through debt, and arrange that they pay back inflated interest to subsidiaries resident in low-tax jurisdictions. The outcome is a reduced tax liability for the group as a whole. The draft directive sets out to discourage this practice by limiting the amount of interest that the taxpayer is entitled to deduct in a tax year.

Exit taxation rules. Corporate taxpayers may try to reduce their tax bill by moving their tax residence and/or assets to a low-tax jurisdiction. Exit taxation prevents tax base erosion in the state of origin when assets that incorporate unrealised underlying gains are transferred, without a change of ownership, out of the taxing jurisdiction of that state.

General anti-abuse rule. This rule is intended to cover gaps that may exist in a country's specific anti-abuse rules. Corporate tax planning schemes can be very elaborate and tax legislation doesn't usually evolve fast enough to include all the necessary defences. A general anti-abuse rule therefore enables tax authorities to deny taxpayers the benefit of abusive tax arrangements.

Controlled foreign company (CFC) rules. In order to reduce their overall tax liability, corporate groups can shift large amounts of profits towards controlled subsidiaries in low-tax jurisdictions. A common scheme consists of first transferring ownership of intangible assets such as intellectual property to the CFC and then shifting royalty payments. CFC rules reattribute the income of a low-taxed controlled foreign subsidiary to its - usually more highly taxed - parent company.

Hybrid mismatch **r**ules. Corporate taxpayers may take advantage of disparities between national tax systems in order to reduce their overall tax liability. Such mismatches often lead to double deductions (i.e. tax deductions in both countries) or a deduction of the income in one country without its inclusion in the other.

From a UK perspective, the EU Referendum result means that it is not clear whether the UK will follow the EU implementation or choose its own course. This is discussed in the following section of this paper.

The impact of the EU referendum

The EU referendum result had an immediate effect on the real estate investment management industry. Open-ended funds available for retail investors generally provide for daily pricing and daily trading. Such funds had already been facing rising redemptions in the period prior to the referendum result. In the immediate aftermath of the result, redemption requests rose very significantly. Shares in REITs dropped significantly in value and valuers caveated the valuation opinions for the values used by the managers in calculating the fund Net Asset Value (NAV) for subscription and redemption pricing. Fund managers responded differently with many suspending redemptions in the funds and / or making adjustments to redemption prices.

As mentioned earlier in this paper, the Association of Real Estate Funds (AREF) has announced that John has been appointed to undertake an independent review of the impact of the referendum result on real estate funds and to evaluate whether any improvements could be made to deal with market shocks in the future. The primary focus of the research will be to assess the impact on clients following the referendum, but it will also take a view of the whole market including fund distributors, managers, valuers and other service providers. It will also look to identify areas where market participants believe there might be aspects of manager or investor behaviour for which 'best practice' might be established by AREF itself or the regulator. The research will be published in the first quarter of 2017.

The fund management industry in the UK also faces uncertainty from the current lack of clarity regarding the country's relationship with the EU in the future. A number of the regulatory provisions described in this report are governed by EU Directives, in particular AIFMD, Solvency II `and IORP II. It is currently not clear whether the UK will in the future have access to financial services passporting. As has been mentioned already in this report, significant progress had been made in grouping a number of these areas together in the Capital Markets Union (CMU). It is now entirely possible that the UK will lose access to the CMU just as it starts to deliver many of the benefits.

The UK has already lost significant influence. The Capital Markets Union initiative was being driven by the EU Commissioner responsible for Financial Services who was the UK Commissioner Jonathan Hill. He resigned after the EU referendum result and the UK lost this influential role.

Within the EU, the response to the OECD BEPS initiative is being conducted on a pan-EU level. Post exit, it is not clear if the UK would seek to adopt the same approach as the EU within the broad framework set by the OECD, or follow its own path.

The nature of the UK's relationship with the EU going forward is still extremely uncertain. We have no clear picture as to the timing of triggering Article 50 to begin exit negotiations, the UK's strategy in terms of the importance or otherwise that the government attaches to access to the single market for financial services and the response from the EU side in the negotiations. This should gradually begin to emerge from the mist over the next year.

Our post Brexit blog can be found here: http://www.johnforbesconsulting.co.uk/brexit-blog/ and the materials from the INREV Public Affairs webcast on Brexit in which John spoke can be found here: http://www.johnforbesconsulting.co.uk/inrev-brexit-call/

What next?

In our original paper in 2010, we were alarmed by the range of challenges set to face the real estate industry in the second half of 2012. We produced an update of the report in late 2012, by which time the changes that we had discussed were being phased in over a much longer timescale. At that point, we envisaged that it would be well into 2016 before the effects were fully felt. We are now in late 2016 and the majority of the changes are now in effect or in transition.

The real estate investment management industry has already undergone very significant change since the global financial crisis. However, it still has long term structural issues to address. Regulatory and investor driven changes have increased costs but managers have been sheltered by increased fees from a booming market. The prospect of a prolonged period of more meagre earnings will put pressure on the current operating model. This is particularly true for mid-tier managers.

We see a number of global drivers of change:

Change	Impact
Globalisation of capital and opportunities	Globalisation of both the sources of capital and the investment opportunities is transforming the industry.
Changing attitude of investors	Since the global financial crisis, investors have become increasingly demanding. There is a much greater focus on operational matters, greater intolerance of failings and a need for more comprehensive information delivered more quickly. Improved governance.
Regulation and taxation	The regulatory and tax environment is in a process of very significant change. The EU Alternative Investment Fund Managers Directive came into effect on 22 July 2013, but this is only the start. The next five years will see further significant change.
Technology change	Technology investments support business capabilities driven by customer and market demand. Data proliferation. More rapid systems obsolescence.
Non traditional assets	Expansion of investment into "alternative" real estate types, including private rented sector and healthcare. More complex, more granular and often an operating element. What will be the future "alternatives"?

All of these represent opportunities as well as challenges, but also suggest very significant investment requirements. This may be beyond the resources of any other than the largest investment managers on their own. For others, new business models and new service providers may emerge to allow the pooling of development cost.

Technological advances, such as blockchain, may also help the industry address the persistent problem of the perceived high cost of investing in real estate as an asset class. Technological advance is already seen as a game changer at the asset level, with an explosion of start-ups in proptech. Much of the focus has been in the core area of trading and managing physical assets. For the investment management industry an equally significant change will be in the application of broader fintech advances to the fund distribution model.

The six years since John wrote the original version of this paper have seen very significant changes in the real estate investment management industry. The next six years are unlikely to be any different. There will be many challenges for the industry. For businesses that are already established, the complexity of the environment has an advantage, in that it creates barriers to entry, making it difficult for new players to challenge in a traditional manner. To the extent that there is an opportunity for new entrants, it will be for disruptive change rather than new players in the traditional space.

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