AREF
The Association of Real Estate Funds

The Association of Real Estate Funds Representation

2024 Autumn Budget

Executive Summary

AREF[1] represents over fifty UK commercial real estate funds responsible for over £50bn of pension fund investment into UK commercial property.

We welcome the Government's aim for economic stability and growth. We agree there is a need for the building of more homes, particularly affordable housing, and the infrastructure required to support these such as new hospitals, regeneration of high streets, places for people to work and leisure facilities. Our submission concentrates on changes to legislation, regulations and policies the Government could make to enable the property fund industry to help them achieve these goals. There are other areas, including planning and skills reforms and moving to net zero carbon emissions, where we support the Government's ambitions too. We have not included these in this submission, but we have made, and will continue to make, representation on these other areas.

We would ask that the Government ensure they consult widely on any proposed changes to legislation and regulations, and these are proportionate, consistent and simple to understand and apply. There have been several examples over the last decade or so where these principles have not been applied leading to confusion and additional work for our sector and government departments.

The proposals in this submission for the Chancellor's Autumn Budget relate to:

1. Unlocking of productive investment from defined contribution pension funds and other sources. The proposals are in five areas:

   1.1. Maintaining the current universe of daily-traded commercial real estate funds.

   1.2. Encouraging or mandating third-party DC platforms to hold non-daily-traded assets.

   1.3. Encouraging or mandating smaller DC funds to merge to create funds with scale.

   1.4. Moving DC funds from an Individual Account model to a Collective DC model.

   1.5. Addressing the correct gatekeepers and incentivising them to take managed risk.

2. Reserved Investor Fund

3. Tax reforms

   We have three key tax reforms we would like to see addressed in the Autumn Budget:

   3.1. VAT on fund management.

   3.2. 10% limit for corporate shareholders in a PAIF.

   3.3. Multi Dwelling Relief (MDR).

   3.4. Carried Interest

We hope these proposals are useful and we will be happy to discuss them further.

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[1] **About the Association of Real Estate Funds (AREF)**

AREF is the trade body that represents UK commercial real estate fund managers, those firms that support them and the end customers that invest in commercial real estate funds. Our membership includes over fifty funds spanning the leading commercial real estate fund management houses in the industry, through to smaller specialist boutiques, with a collective net asset value of over £50bn in the UK.

AREF's Submission

1. Unlocking of productive investment from defined contribution pension funds and other sources

AREF fully supports the aim of the Government's pensions review to boost productive investment by defined contribution workplace schemes and the Local Government Pension Schemes.

This paper makes a number of suggestions to help unlock that investment. AREF takes "productive investment" to include that in commercial real estate and infrastructure, as well as other illiquid assets such as venture capital, private equity and private debt. Given AREF's expertise, the thrust of this paper is focused on facilitating investment from UK Defined Contribution (DC) pension funds into commercial real estate and measures which can then be generalised to facilitate investment into other illiquid assets.

Common solutions are possible across these productive asset classes because there is one problem common to them all: liquidity.

The challenge that has been facing the commercial property industry for some time is the decline in investment from Defined Benefit (DB) schemes as they close to new investment and increasing numbers are bought out by insurance companies.

If DC investment in illiquids does not grow to fill the gap left by the decline of DB investment, there will almost certainly be profound consequences. Funding to build more homes will be more difficult, as will financing the net-zero agenda through retrofitting. UK pension funds are the traditional large investors in the UK regions. The other large source of investment, overseas capital from pension and sovereign wealth funds, tends to focus on the larger conurbations and their cost of capital is higher.

Anecdotally, as DB funds redeem their holdings in property funds, we have seen commercial property assets being sold to overseas High Net Worth individuals who will be more likely to focus on short-term value extraction rather than long-term local placemaking. In these circumstances the returns from investment leave the UK, rather than going to UK pensioners, and, in the absence of demand from UK pension sources, commercial property values will fall or rise less than they otherwise would have.

There will be consequences for the pension system too. Including illiquid assets in pension fund portfolios lowers portfolio risk through diversification against equities and bonds and, depending on the type of commercial real estate activity, offers a high level of capital growth or a high level of income. If DC pension funds are unable to access these asset types then we believe that their long-term risk/return levels will be worse, to the detriment of UK pension savers.

Although there are other sources of investment such as charities, private individuals and overseas institutions, in our view UK DC pension funds are the most important source of investment in productive assets in the UK. The sector dwarfs the others in size: as with compulsory auto-enrolment, it is constantly growing; it has a long-term investment horizon and is thus very "sticky"; it is willing to invest in regions of the UK where international investors may not venture; and its cost of capital is lower than that of overseas investors. It is therefore crucial to the UK pension system and the growth of the UK regions that DC investment into illiquid assets is unlocked.

The problems preventing DB investment being replaced by DC are not of a lack of desire on the part of the DC funds, or of regulation - they are operational and structural problems. While the Productive Finance Working Group (PFWG) did much valuable work in the development of the Long Term Asset Fund (LTAF), for these operational and structural reasons take-up has been slow. In our view, there are five areas which remain to be addressed in order to open the tap on DC investment. These are:

1.1. Daily-traded commercial real estate funds

1.2. Platforms

1.3. Pension fund scale

1.4. Collective DC and Defined Ambition

1.5. Addressing the correct gatekeepers and incentivising them to take managed risk

1.1. Daily-traded commercial real estate funds

Currently the only route into commercial real estate investment for most UK DC funds is to invest in the small remaining number of daily-traded open-ended funds. These funds provide daily liquidity for the majority of the time through holding relatively high levels of cash, with rare suspensions under extreme market conditions.

Technically DC funds can also invest in listed Real Estate Investment Trusts (REIT) and Real Estate Operating Companies (REOCs) but these provide an undesirably high level of volatility and low level of diversification against other listed equities. To reduce volatility, investment is generally in global rather than UK REIT shares.

Following the suspension of the Woodford Equity Income Fund in 2019, the liquidity mismatch has come under greater regulatory scrutiny from the FCA, who concluded that they would not impose notice periods until the PFWG had addressed the operational barriers represented by the platforms, referred to in the "Platforms" section below.

This work has still not been done and although notice periods have not yet been imposed, fund managers and their investors have seen "the way the wind is blowing" and have taken their own pre-emptive action. The result has been the withdrawal of pension fund capital from the sector with the closure of a number of the largest daily-traded funds, the loss of over £20bn of investment from UK sources into UK property, and the large-scale transfer of ownership to overseas private equity players who focus on short-term value extraction rather than long-term local placemaking. Many of the daily-traded UK property funds are moving to a model that will not necessitate notice periods by selling their UK direct property and instead investing the majority in listed REIT shares. However, as mentioned above, to reduce volatility, investment is generally in global rather than UK REIT shares.

Our recommendation here is simple: do not close off the only significant avenue for DC funds to invest in illiquid commercial real estate until other avenues have been opened.

We would also like to point out that the demise of many of the authorised daily-traded funds, that are usually structured as Property Authorised Investment Funds (PAIFs) has led to less choice for retail investors who wish to invest indirectly in property. If and when notice periods are introduced for property funds, there will be another disincentive for retail investors to invest through an ISA. HMRC will only permit them to be held in the Innovative Finance ISA, and not the better-known and used Stocks and Shares ISAs.

1.2. Platforms

This is the fundamental obstacle to most DC funds investing in UK commercial real estate - it is structural and operational, not regulatory. In the absence of a solution to this problem, new regulatory structures such as the LTAF will not really help.

The problem is that DC funds mostly invest through third-party platforms ("fund supermarkets") which will only take daily-traded assets, making it impossible to invest in fund structures such as the LTAF which hold unlisted assets such as commercial real estate, infrastructure, private equity and private debt (in other words most assets falling under the definition of "productive finance"). The PFWG was aware of this and issued a call to action in "Investing in Less Liquid Assets – Key Considerations" but so far this has been unsuccessful in addressing the problem.

We believe that there are two ways forward:

(a) Mandate platforms to take illiquid assets, through regulation or legislation.

(b) Encourage the development of alternative DC scheme structures, such as Master Trusts, which do not need to invest through platforms or who can use custody-only platforms.

1.3. Pension fund scale

Real assets such as infrastructure and commercial real estate are large, indivisible and illiquid. In order to construct a properly diversified real assets portfolio, which must be at least around £100 million, a pension fund must therefore itself be of significant size, probably at least £1 billion. We therefore support the Pensions Review aim to drive scale and consolidation of defined contribution workplace schemes, which should increase the capital available for illiquid assets, and also the quality of the resources available to the teams managing such capital.

The models on which Australia and Canada have settled, of a number of very large superannuation funds holding large portfolios of illiquid assets, is one to aim at, as long as there remains a sufficient number of schemes to ensure a competitive, well-functioning market.

1.4. Collective DC and Defined Ambition

At the moment, most UK DC pension funds operate on the Individual Account model, whereby each saver owns a piece of every asset in the portfolio. Thus, if a saver decides to transfer to another scheme, their share of every asset has to be sold meaning that all assets have to be liquid. This eliminates the use of illiquid assets. Under a Collective DC (CDC) structure, a saver owns a share of the value of the fund as a whole. If they decide to leave, their share of the value is paid to them out of the liquid assets (cash, equities, listed fixed interest) and the proportion of illiquid assets in the portfolio rises a little.

Australian superfunds use this structure and are a good model, owning around 20% of illiquid assets and allowing that proportion to fluctuate between, say, 15% and 25%. They are some of the largest owners of commercial real estate and infrastructure in the world and, as the Government will be aware, some Australian super funds are opening London offices to coordinate their UK and European investment programmes, including real estate, illustrating the potential that scalable DC schemes could have in the UK market.

Some UK Master Trusts are developing in this direction and this needs to be encouraged further.

1.5. Gatekeepers

In recent years, the focus of regulatory developments has been on retail investors and on the “democratisation” of investment. This has obscured the fact that the vast majority, over 90%, of savers in DC pension schemes do not untick the default portfolio box, so the portfolio allocation decision is left to the fund management company. In other words, the archetypal DC investor is in reality not an individual, but an institution. Therefore, efforts to encourage investment in illiquid assets do not need to be addressed to individuals, but to institutions and their advisers. This means investment consultants, the in-house teams of the very large DC schemes and the remaining large DB schemes (in particular local authorities).

2. Reserved Investor Fund

AREF strongly supports the Reserved Investor Fund (RIF) proposal. It is now widely recognised that the RIF will plug a gap in the UK fund offering. Furthermore, the RIF will be able to attract UK and international pension fund as well as institutional capital. The RIF will be efficient to launch and operate compared with alternative onshore and offshore vehicles. The lower total expense ratios which will be achievable with the RIF means greater returns for RIF investors and therefore, ultimately, for members of pension schemes. The RIF should make the UK a more attractive location to set up, manage and administer funds, as well as supporting a wider range of more efficient investments better suited to investors’ needs.

We urge the government to use the Autumn Budget 2024 to implement regulations making provisions for the RIF as indicated in the RIF primary legislation: Financial Services and Markets Act 2023, section 64 and Finance (No.2) Act 2024, section 20. This would enable UK fund managers to launch RIFs later this year.

3. Tax reforms

3.1 VAT on fund management

Prior to 1 January 2024, it was possible to rely on the direct effect of EU law to claim exemption for the management of funds that were not on the VATA list but which fell within the EU VAT Directive version of the fund management exemption as a result of being "special investment fund" (SIFs). However, since that date, it is no longer possible to rely on direct effect to quash or disapply UK VAT legislation (Retained EU Law (Revocation and Reform) Act 2023 section 2 and Finance Act 2024 section 28), although it is possible to rely upon direct effect for interpretation. This distinction leads to some uncertainty on the scope of the fund management exemption from 1 January 2024, which HMRC has sought to address.

In light of the broad VAT exemptions available for fund management in competitor markets, the current funds VAT regime, as well as the significant uncertainty over its interpretation, is likely to continue to make the UK a relatively less attractive domicile for funds and will drive further activity offshore.

As a RIF is a new vehicle and is not expected to be added to the list of fund vehicles in Items 9 and 10 of Group 5 of Schedule 9, it is assumed that management of a RIF will not fall within the exemption. Accordingly, supplies of fund management to a RIF will be standard rated (20%) for VAT purposes. This should allow fund managers to recover their related input VAT on these VATable supplies. It should be noted that CoACSs are on the VATA list.

These consequences mean that for RIFs investing in residential real estate (and other asset classes which do not give rise to input recovery for the fund), VAT charged on fund management fees will be a material commercial cost and, accordingly, reduce the RIF's attractiveness. This issue could be addressed for those RIFs by adding the RIF to the

VATA list, however, this would make it a less competitive structure for RIFs investing in commercial real estate (and other classes which do give rise to input tax recovery for the fund), as fund managers would no longer be able to reclaim their own related input VAT. The RIF Experts Group would like to discuss with the Government a proposal that government grants a RIF fund manager (on behalf of the RIF) the option for the management supplies to a RIF to be exempt. This would sit alongside the default option that the fees would be VATable absent exercise of the option.

3.2 10% limit for corporate shareholders in a PAIF

The 10% limit for corporate shareholders in a PAIF is outdated and unnecessary. Removal of this limit for most shareholders (to mirror the equivalent changes made to REITs in FA 2022 and FA 2024) would remove the need for costly feeder fund structures and would also prevent adverse impacts for seed investors particularly during the early stages of a fund's life, both of which act as barriers to entry for the PAIF regime.

3.3 Multi Dwelling Relief (MDR)

The abolishment of Multi Dwelling Relief (MDR), from 1 June 2024, will make it more costly for the build to rent (BTR) sector, just at a time when the Government is trying to attract more investment in new homes. We would like to see MDR reinstated.

3.4 Carried Interest

While the use of Carried Interest has traditionally been less common in AREF's fund membership, many of the larger real estate fund managers are now expanding their product offering into 'value add' and more entrepreneurial, development driven investment propositions. This sector of the real estate fund market increasingly uses methods similar to the private equity industry to ensure alignment between the fund manager and investors from the perspective of incentivising strong performance. In an environment where development of new housing stock and the ESG driven upgrade of existing commercial property is a key contributor to the UK's built environment and environmental objectives it is critical that such incentivisation mechanics can operate to maximise the contribution of this growing sector to the stock of both residential and commercial real estate.

We are aware of the recent call for evidence in relation to the taxation of Carried Interest and we would endorse the comments of our colleagues at The Investment Association in their response. In particular we would encourage the Government to ensure that if any changes are implemented that they are proportionate, well-considered, well-consulted, simple to understand and apply. There is a high risk that significant changes to the presently well understood regime may have unintended consequences and may drive both key personnel location decisions alongside underlying investment decisions leading to a fall in the level of direct UK investment and negatively impacting the UK's position as a leading hub for private capital. We would encourage the use of grandfathering provisions for existing structures and allow for orderly transition to a new regime, should the Government decide to implement changes.

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