AREF
The Association of Real Estate Funds

HM Treasury

Response by online survey on 25 September 2024

Response to Pensions Investment Review: Call for Evidence

Scale and consolidation

1. *What are the potential advantages, and any risks, for UK pension savers and UK economic growth from a more consolidated future DC market consisting of a higher concentration of savers and assets in schemes or providers with scale?*

   Larger DC schemes tend to have more in house specialist investment expertise. This means they can invest in a wider range of assets for their members, including less liquid assets, enabling them to reduce investment risks. DC schemes have a high proportion of younger savers whose contributions should be in long-term investments which are more likely to be illiquid.

   Other key advantages of the consolidation of the DC market include economies of scale, greater investment in member experience and enhanced governance structure.

   We suggest the Government consider encouraging DC pension schemes for particular industries. This would reduce the need for many savers to have to move pension scheme when changing employers; most people stay within the same industry when moving jobs. This would make it easier for savers to keep tabs on their pension and save them having to think about consolidating their pension. Also, this would reduce administration costs for the pension schemes themselves.

   One of the risks of creating a small number of large DC schemes is that it could lead to less competition, and therefore less choice for members, and distortion of the markets.

   We warn against the driver for consolidation being cost savings. If funds are to invest in some complex productive assets at scale, they need to be well advised and managed by experienced managers, driving costs to the lowest common denominator is counterproductive.

2. *What should the role of Single Employer Trusts be in a more consolidated future DC market?*

   We understand that many Single Employer Trusts are moving into master trusts, which can provide some of the advantages of a large scheme. We consider this consolidation to be a good thing. However, if the scheme were large enough, a Single Employer Trust may be viable.

3. *What should the relative role of master trusts and GPPs be in the future pensions landscape? How do the roles and responsibilities of trustees and IGCs compare? Which players in a market with more scale are more likely to adopt new investment strategies that include exposure to UK productive assets? Are master trusts (with a fiduciary duty to their members) or GPPs more likely to pursue diversified portfolios and deliver both higher investment in UK productive finance assets and better saver outcomes?*

   Trustees have a fiduciary duty to scheme members and IGCs are required to act solely in the interest of scheme members. Therefore, pension schemes, regardless of their structure, will only invest in UK productive finance assets if they are competitive compared to other types of investment and meet the needs of the savers in the scheme.

   We agree with the views expressed by government in November 2023 (https://www.gov.uk/government/calls-for-evidence/pension-trustee-skills-capability-and-culture-a-call-for-evidence/outcome/6741d14b-468d-4c18-b7bf-f1829c8da3f3, paragraph 2):

   > "*Ensuring that all actors in the pension system are making balanced, thought-through, and well-advised decisions is essential to ensure good outcomes for savers. We know that the pensions landscape is evolving*

and becoming more complex. Pension trustees and those who advise them need to be properly equipped, supported, and regulated to meet the demands of this role".

To ensure pension trustees meet their fiduciary duties the scheme members it is important that they maintain their independence and also, we strongly suggest that the professionalism of trustees continues to be improved through education. AREF is currently working on an education package explaining the benefits of investing in real estate.

Over the last few years, culminating in the Mansion House Reforms, the Government has had some success in encouraging small DC pension schemes to move into master trust arrangements which provide the investment advantages of large schemes; This was noted in the Department for Work & Pensions report "Trends in the Defined Contribution trust-based pensions market" (https://assets.publishing.service.gov.uk/media/655c8ff7d03a8d000d07fda2/trends-in-the-trust-based-private-pensions-market.pdf) published in November 2023.

However, it should be noted that there is an inherent conflict of interest between those master trusts that are operated by investment managers where in practice the master trust platforms might focus on the products offered by the "in-house" investment managers (and not products offered by other investment managers). This can unfairly limit the choice of investments available to savers in the master trusts: the investments being offered by the "in-house" investment managers are not necessarily the best-in-class investments. Enhanced corporate governance within the master trusts could help improve both accountability and saver outcomes. In addition, the Consumer Duty should apply to the master trust platforms so they provide a diversity of products taking into account the outcomes for savers.

At the moment, most UK DC schemes 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 severely restricts the ability to use 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. Some UK master trusts are developing in this direction and the Government should consider encouraging this further.

4. *What are the barriers to commercial or regulation-driven consolidation in the DC market, including competitive and legal factors?*

5. *To what extent has LGPS asset pooling been successful, including specific models of pooling, with respect to delivering improved long-term risk-adjusted returns and capacity to invest in a wider range of asset classes?*

It is taking time for LGPS to consolidate their current investments in real assets many due to the nature of the assets so we do not see this as an issue. What is more important is that the pooling of LGPS has enabled them to assemble in-house expertise and invest direct in more core balanced real estate, thereby reducing management costs. Where they do not have the expertise, there is evidence that the LGPS are investing more actively in investment vehicles managed by fund managers with expertise in specialist real estate strategies, for example in affordable and social housing. Such specialist strategies have the potential to generate better returns for savers as well as positive economic and social impacts compared to the core balanced real estate strategies traditionally pursued by individual LGPS. Also, where necessary the LGPS pools co-invest in large projects, so we do not believe that there is a need for them to consolidate any further.

We assume LGPS have been providing data to the Government showing show how fees have been reduced due to pooling. The fee reduction has been achieved in part by putting management of investment portfolios out to competitive tender. We would caution against prioritising low costs over providing value for money. Whilst we expect that cost savings are being made, the pooling of real assets has not generally been in place long enough for the long-term effects of pooling on risk-adjusted returns to be properly assessed.

Costs vs Value

1. *What are the respective roles and relative influence of employers, advisers, trustees/IGCs and pension providers in setting costs in the workplace DC market, and the impact of intense price competition on asset allocation?*

   We cannot comment on the roles and influence stakeholders have on setting costs in the workplace DC market. However, we have been supportive of the joint initiative by the Department for Work & Pensions, the Pensions Regulator and the FCA to produce a value for money framework for pension schemes. Prioritising lower costs over value for money is not always beneficial to savers in pension schemes. We have yet to see much evidence of individual schemes or the master trusts moving away from an excessive focus on fees. The removal of well-structured performance fees from the charge-cap should encourage a more partnership-based relationship between schemes and managers, but again we have yet to see this in practice.

2. *Is there a case for Government interventions, aimed at employers or other participants in the market, designed to encourage pension schemes to increase their investment budgets in order to seek higher investment returns from a wider range of asset classes?*

   In recent years, the focus of regulatory developments has been on retail investors. However, according to a study by the Pensions and Lifetime Savings Association, approximately 90% of savers in DC schemes invest in the default fund and leave the allocation decision to the fund management. Consequently, efforts to encourage investment in illiquid assets should be addressed to the funds themselves and their advisers.

   DC schemes are usually structured so that if a saver decides to transfer to another scheme, their share of every asset has to be sold. Consequently, the third-party platforms, used by most DC schemes, have based their model on providing daily liquidity. This makes it harder for DC schemes to invest in fund structures, such as the LTAF, which hold unlisted illiquid assets. The Productive Finance Working Group 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 would like the Government to mandate through regulation all platform providers to be open to onboard non-daily dealing products. For instance, the Consumer Duty should also apply to the platform providers so:

   - they provide a diversity of liquid to less liquid products taking into account the outcomes for savers and the need to optimise long-term returns; and
   - if they only offer daily dealing products, they need to justify to consumers why daily liquidity is necessary and beneficial, with a particular emphasis on the appropriate liquidity needs of different age cohorts.

   Currently the only route into illiquid assets for most DC schemes is to invest in daily-traded open-ended property funds. They can invest in listed REITs and REOCs but these provide an undesirably high level of volatility. Liquidity mismatch has come under greater regulatory scrutiny and (we understand) the FCA plan to consult further on imposing notice periods for the daily-traded open-ended property funds when the operational barriers from investment platforms have been resolved. Some fund managers and their investors have been taking pre-emptive action resulting in from the closure of some daily-traded property 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 have told us, to avoid being within the notice period rules, they are selling the majority of their UK direct property and investing in listed global REIT shares which tend to be less volatile than UK ones.

   There needs to be a move away from structures being used to improve liquidity rather than address the tax and investment needs of investors.

   In addition, we would encourage the Government to look at ways of improving the liquidity of some of the underlying illiquid assets. For example, real assets are under served by a Land Registry which could operate more efficiently: utilise technology to speed up the Land Registry processes.

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Investing in the UK

1. *What is the potential for a more consolidated LGPS and workplace DC market, combined with an increased focus on net investment returns (rather than costs), to increase net investment in UK asset classes such as unlisted and listed equity and infrastructure, and the potential impacts of such an increase on UK growth?*

   LGPS pools are of a size that they can have their own in-house experts and invest direct in core balanced real estate. Also, LGPS pools can co-invest in large projects. This investment is likely to be in the UK as its easier to oversee and manage. Where they want to diversify into property where they do not have the expertise, they can use investment vehicles managed by fund managers with the specialist knowledge. This provides a mechanism for LGPS to invest in the UK economy while keeping investment decisions independent from local government's role and reputation. Funds provide a barrier between the actual real estate assets and the LGPS which could protect them against reputational risk.

   The caveat to this is that investing in UK productive assets would have to provide a good return for savers compared to other long-term investments to enable the DC schemes and LGPS pools to meet their fiduciary responsibilities.

   In respect of DC schemes, the main obstacle is the unwillingness of investment platforms to update their systems to accommodate assets with notice periods. If blockages to investing through funds in illiquid assets are not resolved, REITs will likely be used as an alternative to obtain exposure to real estate and infrastructure. However, REITs have a high level of volatility so to reduce this global REITs are usually chosen over UK REITs.

   We warn against Government mandating investment in UK productive assets. Government should pursue policies to ensure these assets are competitive when compared to other long-term investments.

   The purpose of a pension is to deliver a secure financial future for pension fund members. For trustees of pension schemes, delivering this financial security is their primary duty and is underpinned by strict fiduciary obligations. The Government is understandably exploring the examples set by Australian pensions schemes, with a greater allocation to productive assets, and Canadian pensions schemes, given the scale of their investments. However, in both cases these schemes benefit from independence, and their investments are not subject to mandates from their national governments. Mandating investment would be counterproductive to the UK's reputation for attracting global finance and also in conflict with the duty of trustees to their members.

2. *What are the main factors behind changing patterns of UK pension fund investment in UK asset classes (including UK-listed equities), such as past and predicted asset price performance and cost factors?*

   Investment by pension schemes in their domestic market is one of the lowest, globally, in the UK. There will always be a cylindrical nature to investment, with the UK markets not always being the best for investment. However, one reason for less investment by pensions schemes in the domestic market is that they have been encouraged to derisk and are therefore taking a more global investment approach.

   Another reason for the changing pattern of UK pension fund investment in UK asset classes is the move from DB schemes to DC schemes. As we explained in our response to 'Costs & Values' Q2, due to the structure of DC schemes they look to invest more in liquid rather than illiquid assets, unlike DB schemes that have tended to hold a large portion of their funds in illiquid assets.

   In terms of domestic equity exposure and as a global trend in the major pension markets, there is "a sign of a reduced home bias in equities over the past 20-year period. The weight of domestic equities has fallen, on average, from 67.1% in 2002 to 37.7% in 2022" (https://www.thinkingaheadinstitute.org/research-papers/global-pension-assets-study-2023/, slide 34). In addition, the New Financial report 'Comparing the asset allocation of global pension systems', (https://www.newfinancial.org/reports/comparing-the-asset-allocation-of-global-pension-systems) usefully highlights:

   > "*the proportion of their assets that UK pension funds allocate to UK equities has fallen to 4.4%, compared with our estimate last year of 6.1% and down from over half of their assets 25 years ago. This disguises big differences between the main 'buckets' of pensions in the UK: corporate defined benefit schemes allocate just 1.4% to UK equities, public sector defined benefit schemes 9%, and defined contribution pensions around 8%.*

….this allocation to domestic equities is among the lowest of any developed pension system around the world with only Canada, the Netherlands, and Norway having a lower allocation. It is less than half the weighted average allocation to domestic equities across our sample excluding the US. The overall allocation to equities by UK pension funds of 30% is lower than every market except Canada, Denmark, and the Netherlands.

……the main drivers of this decline have been the de-risking of private sector DB schemes and the shift across UK pensions from a 'UK centric' approach to a global market-weighted approach to equities with investment allocated broadly in line with a market's weighting in global indices. As UK pensions have switched out of UK equities, they have helped feed a doom loop of lower demand, lower valuations, and a less dynamic market".

3. *Is there a case for establishing additional incentives or requirements aimed at raising the portfolio allocations of DC and LGPS funds to UK assets or particular UK asset classes, taking into account the priorities of the review to improve saver outcomes and boost UK growth? In addition, for the LGPS, there are options to support and incentivise investment in local communities contributing to local and regional growth. What are the options for those incentives and requirements and what are their relative merits and predicted effectiveness?*

We advocate tax incentives to facilitate investment in real estate and infrastructure by pension schemes. Changes in tax policies could encourage private investment alongside the pension schemes.

It would be helpful if HMRC could provide clarity that income and gains that arise from UK real estate and infrastructure will fall under the pension scheme income tax exemption (section 186 of Finance Act 2004) and the capital gains exemption (Section 271(1A) Taxation of Chargeable Gains Act 1992) respectively. Further confirmation on the types of UK real estate and infrastructure that qualify as investment assets would also be welcomed.

There is full recovery of VAT when investing in commercial real estate but this is not the case when investing in residential which leads to a reduction in returns and discourages investment in residential housing such as affordable and social housing.

AREF strongly supports the Reserved Investor Fund (RIF) proposal. It is widely recognised that the RIF will plug a gap in the UK fund offering. The RIF will be particularly attractive to LGPSs when investing indirectly in UK real estate and other productive assets – in addition to being attractive to other pension schemes (UK and international). 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 the LGPS and other pension schemes. 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.

We ask the Government to ensure that existing grant funding schemes that are essential for many local investment projects are carried through and made simpler and quicker to access and deploy.

A significant disincentive to investment in the development of new UK property and infrastructure by institutional investors is the cost, uncertainty and delay associated with the UK planning system. We know the Government is looking at reform in this area. In our experience the reason for many of the delays in the planning system is a severe lack of resource (experienced planning officers) rather than a fundamental problem with the planning system itself.