XPS Investment

XPS Insights
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FCA consultation on property fund notice periods – what are the implications for pension schemes?

The FCA has issued a consultation introducing lengthy notice periods for some retail focused property funds in the pursuit of protecting investors. In this short note, we highlight the potential issues these proposals could create for DB and, most prominently, DC pension schemes.

What you need to know

In August 2020, the FCA announced a consultation in relation to a select range of retail property investment funds, specifically Non-UCITS Retail Schemes or NURS.

The consultation which closes on 3 November, seeks to reduce investor harm that arises from investing in daily dealt property funds where it may take months to sell underlying assets. This mismatch means that the investment manager either:

> holds large amounts of cash to meet the possibility of redemptions which acts as a drag on investment returns; or

> has to reserve the right to suspend trading in the units if redemptions exceed readily available assets. A suspension means that no one will get any money until the suspension is lifted.

The FCA proposes that investors must notify fund managers in advance that they want to redeem their investment. The FCA is consulting on the precise length of this notice period but is proposing a period of between 90 and 180 days.

The FCA's aim is to enable funds to operate fairly and efficiently in the interests of all investors. The introduction of a notice period would seek to deliver an increase in returns through reduced cash drag.

XPS Investment's view

- Due to the retail fund focus, many DB schemes investing in property will not be affected by this consultation but those that are invested in the funds affected will need to revisit their requirements for liquidity.
- XPS believes there is scope for considerable unintended consequences in the DC schemes should this change be introduced in isolation.
- We propose that other wider considerations be factored in so as not to inadvertently reduce investment in illiquid assets within DC schemes.
- DC schemes should review the implications of any changes on their platform providers, check how appropriate these funds are for default funds and examine their communication strategy around these funds.

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Background

Following the spectacular failure of Neil Woodford's Equity Income fund in 2019, ensuring that a pooled fund's liquidity is aligned with its underlying investments has come under scrutiny. The fund was pushed over the edge by a large redemption request that couldn't be met through sale of underlying holdings, ultimately leading to the collapse of the fund along with Woodford's investment management business.

Whilst there were a number of specific aspects to that story, the FCA has faced some criticism over funds being permitted to invest in assets that are less liquid than the pooled fund itself.

Property fund focus

Property has been a keen area of focus, not least because it is one of the most common illiquid investments that can be accessed via daily traded funds and because suspension has become a common occurrence.

In 2016, a number of property funds either suspended dealing or 'gated' redemptions (where redemptions are delayed) following the Brexit referendum on 23 June 2016. Further, this year at least 17 property funds closed because valuers had stated "material uncertainty clauses" since the UK went into lockdown following the spread of the global COVID-19 pandemic. The majority of these announced reopening's for September or October this year, but this still leaves 6 that have not announced a reopening as of yet.

The FCA acknowledges that that the changes being proposed would not have prevented a large number of funds suspending trading this year, given that this was the result of an inability to obtain verifiable property values. That said, the longer notice period would have reduced the impact of temporary suspensions, as investors would have already known that they would not be able to redeem their assets immediately.

Impact on Defined Benefit (DB) pension scheme investors

The specific funds captured under the proposed change (i.e. NURS funds) are not typically used by DB schemes to access property, although some do. Where a DB scheme is invested in an affected fund, we would not see any major issue with the change. That said, for schemes affected, it will be important to review the overall liquidity profile of the scheme to ensure this does not create unforeseen issues. This would be significant if, for example, a DB scheme were close to wind-up, where all scheme assets are being liquidated in the near term. This might require some action to disinvest assets in advance and would need to be factored into the wind-up timescales.

Impact on Defined Contribution (DC) pension scheme investors

There are a number of potential challenges that the proposed changes could have on DC schemes:

Are platforms ready?

Many DC schemes operate on investment platforms. These typically run only daily-dealt funds. The introduction of 3 or 6 month notice period funds would require them to re-engineer their systems. Additionally, administration systems that have been set up to run with these platforms would have to re-work their systems and communications. A possible consequence of this is that DC schemes decide that the best solution is to exclude funds with long notice periods, thereby removing their allocation to property altogether.

This links to the wider direction of travel. The government is keen for schemes to offer more 'illiquid' funds to DC members such as infrastructure and some credit investments for example. The pension industry is also supportive of this evolution. The belief is that DC members saving into an illiquid fund will be invested for forty years or more and consequently a six month notice period can be easily managed. The proposed changes to property funds could prompt the bringing forward of this wider beneficial change in the DC marketplace.

Too illiquid for default funds?

Care would be needed where long notice period funds are used in default arrangements, as this would introduce wider delays into asset transitions within the fund adding additional complexity. This could lead to property being dropped from default funds, even where the funds are available for members as a self-select option.

As default funds account for the vast majority of invested assets, if misjudged the impact of a change could be a wide-scale reduction in the use of property within the DC market.

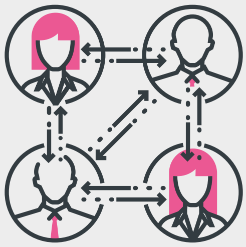
Member confusion

Complications and frustrations may arise with the use of long notice period funds in situations where:

- the member requests a transfer value;
- funds are requested on the death of a member; or
- a member wants to take tax free cash and discovers too much of their funds are locked in.

A possible side-effect is that the UK DC market overall, actually reduces its investment in property as a consequence of these changes. This is not the intended consequence and needs to be considered. We note the FCA recognises the potential for wider impact and specifically requests comments on their proposal as part of the consultation.

XPS Investment's view



XPS welcomes the FCA consultation that some existing daily dealt funds should be changed to a 90 or 180-day notice period.

However, in order for the change to have the desired effect, we propose that other changes are required in the industry to address some of the side-effects we have highlighted.

Specifically, within the DC market we recommend:

- changes to investment platforms, so as to permit illiquid funds to be included as a mainstream offering available to the DC market as a whole
- a focus on clear member communication to address any impact on the change of their access to funds
- a regulatory approach that permits scope for some property funds to continue trading daily, subject to satisfying appropriate requirements around cash reserving and investor protections. This would ensure that, where applicable, the daily trading status can be relied upon with the same level of confidence as any other daily traded pooled fund investment, whilst encouraging greater choice of fund types to suit different investment requirements

XPS will be representing these views within our formal response to the consultation which closes on 3 November.

For further information, please get in touch with Simeon Willis or Jonathan Lawlor.

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