Property: another COVID-19 victim

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12 August 2020

*This blog provides an overview of the impact of COVID-19 on open-ended property funds and is aimed at the interested observer within the industry; an understanding of property funds, fund management and insurance is assumed. The views, thoughts, and opinions expressed in this blog belong solely to authors Lizzie Waghorn and David Mitchell of the IFoA's Finance and Investment Board, and do not represent the views, thoughts or opinions of the authors employer or organisation.*

Below we explore the decisions considered by management when suspending an open-ended property fund. Each fund has a varying amount of capital as investors buy and sell units; capital is invested directly in property and liquidation of assets may be required when units are disposed of. This differs to closed-ended funds, where there is a fixed pool of capital and units can be bought and sold in the market without the requirement to liquidate property assets.

COVID-19 has impacted multiple asset classes and property is no exception. In mid-March there was a swathe of open-ended property funds suspending; they shut their doors to both subscriptions and redemptions. Retail property valuations were already under pressure before COVID-19 struck with the changes taking place on the high street. COVID-19 has, however, introduced some new uncertainty and changes, in particular around the nature and ongoing requirements for Retail, Warehouse and Office space given the way people may work, shop and travel going forward.

The rationale for fund suspension has been different this time around; historically funds have suspended due to liquidity concerns. For example, risk aversion increased following the Brexit referendum and fears of falling property prices increased withdrawals. Insufficient liquidity forced some funds to suspend. The ability to suspend a fund has been, and continues to be, a method of protecting the fund, and hence the investors remaining within the fund, from being a forced seller of property.

The suspensions owing to COVID-19 have been driven instead by “Material Valuation Uncertainty”. The lack of comparable sales in the market, and uncertainty regarding tenants’ continued profitability and consumer demand following the lockdown measures, has resulted in a material uncertainty on the value of a property.

In September 2020, new requirements set out by the FCA will come into force; one requirement for non-UCITS retail schemes (NURSs) means that funds holding inherently illiquid assets, such as property, will have to automatically suspend when valuers identify material valuation uncertainty over the pricing of 20% or more of the fund assets. This requirement, whilst not yet in force, appears to have been adopted by fund managers already, and by funds where this new requirement would not apply e.g. non-authorised funds.

This blog explores some of the issues and questions that managers of authorised open-ended property funds and associated linked life assurance contracts will have considered when deciding to suspend funds and the knock-on impacts of doing so. It also considers market-wide issues and the potential development of open-ended property funds going forward.

In-house issues and considerations:

Governance – Good, proactive governance is essential; those making key decisions need to have all relevant information to hand in order to make fair decisions for their policyholders. Property fund suspension is likely to have heightened the need to move quickly, involve relevant stakeholders, maintain governance processes and ensure decisions and actions are recorded. It may be necessary to consider how well the current governance structures are set up to deal effectively with the need to take decisions in reduced timeframes.

Treating Customers Fairly – The decision to suspend a fund is driven by the requirement to treat customers fairly. Property prices have a direct impact on the unit price of the property fund, and of any other funds invested in the property fund. The inability to accurately determine the value of properties which represent a material proportion of a fund will lead to unit price uncertainty. Suspending the fund is the fairest outcome for all policyholders. Consideration needs to be given to funds which have a holding in a property fund e.g. managed funds, and the determination of the price of these funds.

Financial hardship and lump sum payments on death – Property funds can be held directly by unit linked policyholders via insurance companies and pension funds. The holdings may pay out on a regular basis during retirement and / or pay out a lump sum on death. Where regular payments from a suspended fund previously represented a substantial proportion of their income, insurers and pension schemes will have to determine under what circumstances they may pay out to ensure they achieve good customer outcomes. If the insurer or pension scheme does pay out, who takes on the resulting exposure to the property fund? How does this interact with Treating Customers Fairly for other policyholders? Insurers and pension schemes also need to consider what happens on the death of a policyholder where the policy pays out a lump-sum. The same considerations apply.

The role of the Pricing Committee and Valuation teams – The Pricing Committee and Valuation teams will need to consider if and how to allow for the material uncertainty in the unit prices of the property fund, and how this is reflected within the calculation of the unit price of funds invested in the suspended property fund which have remained open. How will they ensure confidence in the pricing, particularly with a requirement to treat customers fairly across all funds?

Operational impacts – There are likely to be increased operational requirements and complexities following a fund suspension. Considerations may include the following.

- What products are impacted and what are the attached Terms & Conditions? Are insurers able to cease contractual payments and are there restrictions as to how long they can suspend payments for.
- What are the communication expectations of policyholders and regulators? Are customer helplines aware and up to date with the latest information?
- Are regulatory requirements being met?
- Are the operational systems able to suspend fund flows? If not, what changes need to be made and what are the knock-on impacts?

- For insurance and pension products, can withdrawals be funded from other policyholder funds? Can the operational system deal with this? If so, are there other implications for the policyholder (e.g. tax implications)?

Tenant Engagement – In the UK various measures and protections have been put in place to support tenants as companies face extreme cash flow difficulties and have been unable to pay their rent; for example, under the current Code of Practice for commercial property relationships during the COVID-19 pandemic, landlords are prevented from forfeiting commercial leases from non-payment of rent. Going forward, fund managers will have to balance the need for income and the need to meet investors return expectations and cash flow, with supporting their tenants. Tenant engagement is likely to have increased in priority over the last few months in order to understand the impact COVID-19 has had on their ability to pay rent and agree a plan going forward to recover or forfeit any rent arrears.

Lifting the fund suspension – Independent Valuers will continue to value each property throughout suspension and will determine whether material uncertainty remains over the pricing of a property or whether this uncertainty no longer exists. As the number of properties where material uncertainty exists over their pricing reduces, the proportion of the fund captured by material uncertainty will fall. Governance bodies and fund managers will be guided by the Independent Valuer, however they may need to consider what other assurances they require before they are confident in lifting the fund suspension. Initially, a degree of uncertainty will continue as the number of property transactions remain low and may have resulted from distressed sales. What pressure will there be with other funds opening? How will governance bodies have confidence in their opening unit price to ensure they are treating both leaving and remaining investors fairly? For example, there may be a lag in valuation changes as transactions pick up. Continued additional oversight and governance will be necessary to continue to ensure the unit price is appropriate and treats those customers holding property units directly fairly.

Liquidity – liquidity remains a key factor and funds will not want to become forced sellers of property. Fund managers will need to manage the risk of increased redemptions once the suspension is lifted. Are increased redemptions expected, and if so, what level of liquidity is required to meet these? What is the plan and likely timelines for meeting this liquidity target?

Property fund suspensions are likely to have been disruptive to those that are responsible for the funds. This may or may not be the first time experiencing a fund suspension, but ensuring a plan is in place to deal with this scenario is critical. Once back on track, it will be important to review and reflect to see what worked well and what needs to be revised in order to be more robust in the future.

Market-wide considerations

Whilst immediate and specific actions are required at the fund and product level, there are overarching questions about the development of these funds in a post-covid world.

- How might open-ended property funds offering daily liquidity evolve? Irrespective of what the property market may look like, recent events may result in an increase in monthly or quarterly dealing funds where funds invest in illiquid assets. The level of liquidity remains a key factor in the day-to-day management; funds may remain cautious but what are investors' expectations with regards to the level of cash being held within the fund and the impact on return? How aware are investors, particularly the direct retail investor, of the level of cash being held within the fund and how this compares across the market. Crucially, are all investors aware of the role liquidity plays within an illiquid fund and the risks that arise from holding too little cash compared to the impact on returns from holding too much cash?

- Will this change the way customers can invest in a property fund? An investor should understand the risks of their investments and ensure the risks are aligned to their needs and risk profile. Does the market have confidence this is happening in practice, particularly where the investor is a direct retail investor rather than a fund manager investing on behalf of their policyholders? If not, is there a need for self-certification and / or advice requirements when a customer invests directly in a property or other illiquid fund?

- Will fund suspensions become more commonplace? The FCA carried out a review of property funds and liquidity risk following the Brexit. One of the outcomes is the introduction of the “Material Valuation Uncertainty” clause mentioned earlier, and the requirement to suspend the fund should 20% of the properties be captured by material valuation uncertainty. This may lead to more suspensions on a more regular basis, and so the ability to deal with this situation will grow in importance. Do current investors understand this potential for increased suspension, and can they financially withstand this? It is the direct retail investor who is likely to have insufficient knowledge of this new regulation and what this potentially means for them going forward. How can fund managers and insurers support their policyholders in understanding this change?

This blog has only considered the impact on open-ended property funds. However, the impact of material valuation uncertainty will extend to direct real estate holdings, commercial real estate debt and REITs.