Be Visionary

Managing Risks
in the evolving world of Real Estate

The impacts of new regulations on IT systems
Managing Risks in the evolving world of Real Estate

The purpose of this White Paper is to present an overview of the new regulations, to analyze their impact on real estate fund business models, and to suggest some changes to business processes that will help to assure compliance and gain competitive advantage.

New regulations are changing the way the real estate fund management industry operates, and fund managers must adapt accordingly if they are to survive and prosper in the future.

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Foreword

Guillaume Fiastre, CEO, Taliance (top)
Andrew Carey, European Managing Director, RealFoundations (bottom)
Managing Risks in the evolving world of Real Estate | TALIANCE

Introduction

New regulations are changing the face of the real estate fund management industry. Here, RealFoundations analyze the impact they will have on real estate investment funds, specifically in their current business processes, and we will present some suggested changes and solutions to possible threats.

In this White Paper we will begin with a brief description of the real estate fund industry and the regulatory environment. Following this, we will present a set of government regulations that are affecting the global real estate fund sector, specifically in the European Union (EU). We will discuss their objectives, key points, and major issues. Then, we will conduct an impact analysis of the major regulations. Finally, we will analyze the drivers for change and present some suggested modifications in business processes that will help with compliance requirements as well as minimizing risk and improving performance.

The financial crisis has emphasized the need for real estate investors, along with governments, to be more familiar with the most recent developments of all investment operations. This has resulted in emergence of new government regulations in the financial sector. With significant amount of regulations building up, a diversity of parties involved in the real estate investment sector will be greatly impacted as real estate funds are enduring some fundamental structural changes. Investors’ behaviours and where they invest their money are changing, and fund managers will function in an even more complex environment.

Nevertheless, the impact of these regulations does not have to be necessarily a negative one. Fund managers should embrace the change and look for opportunities that will result in gaining competitive advantages over their competitors. The restructuring of business processes and strategies, if done right and on time, will result in many benefits in terms of compliance and performance, thus resulting in more attractiveness for investors. However, in order to gain an edge, managers will need to be very familiar with the new regulations and the areas they will impact. Below we present an overview of the most important regulations, especially those affecting the European markets.

Uncertainty goes hand in hand with opportunity. Only managers capable of embracing the challenge, by identifying the key processes in need of change and acting upon them at an early stage, will enjoy significant benefits from the upcoming changes in the industry.

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Uncertainty goes hand in hand with opportunity. Only managers capable of embracing the challenge, by identifying the key processes in need of change and acting upon them at an early stage, will enjoy significant benefits from the upcoming changes in the industry.
The recent drastic changes to the global economy have significantly altered the business environment for real estate managers. In this section we will examine how these changes came about and the new regulation changes impacting the industry.

Before the global financial crisis, when returns were higher, investors felt comfortable with exercising little direct control over their fund managers. But, starting in 2008, the reversal in upward trends in the credit markets and the financial crisis has had a negative effect on returns. Now, with returns significantly affected by the financial crisis, investors have become more perceptive to the internal control agenda and are demanding for tighter control over strategic and operational decision-making. Also, governments have become more demanding about the control of investment activities, so it should come as no surprise the increased focus on transparency and governance, predominantly in the area of liquidity and risk management.

In response of such demands, governing bodies around the world have spent time developing new policy measures that will affect the investment industry. Among the main developments introduced by governing bodies was to create a more controlled and transparent environment for financial transactions, especially those unusual and risky. The Alternative Investment Fund Manager Directive (AIFMD) is one of a series of regulations introduced by the European Commission that will cover a wide range of the managers and funds’ activities. Regulations that managers and funds will have to adapt over the next few years are Solvency II, Basel III, European Market Infrastructure Regulation (EMIR), Dodd-Frank, and Foreign Account Tax Compliance Act (FATCA) among others. The main goal of these regulations is to offer improved investor protection at both a macro and micro level by building more accurate risk and liquidity profiles for fund products.

Alternative Investment Fund Manager Directive (AIFMD)

The Alternative Investment Fund Manager Directive (AIFMD) is a regulation introduced by the European Parliament in an effort to establish tighter controls over the alternative investment fund industry in Europe. The EU Parliament approved the Directive on 11 November 2010 and it is expected to be implemented by member states of the EU by July of 2013. The proposed law will put alternative investment fund managers under the supervision of an EU regulatory body. The final consultation paper issued by the European Securities and Markets Authority required all comments by 1 February 2013.

The purpose of the Directive is to create a comprehensive and effective pan-European regulatory and supervisory framework for alternative investment fund managers (AIFMs) in order to provide tough and harmonized regulatory standards and to enhance transparency of the activities conducted by AIFMs and AIFs towards public authorities and investors. Through this Directive the European Commission hopes to increase monitoring of systemic risk in the financial services arena generally.

Alternative Investment Fund Managers (AIFMs) are defined in the Directive as managers of alternative investments funds, which refers to a vast range of investment funds that are not already regulated at European level. They include hedge funds, private equity funds, real estate funds and different types of institutional fund. Some of the key points of the Directive are listed below:

- The requirement for AIFMs to comply with minimal capital requirements. The minimum amount expected to be set by the Directive is €125,000. However, if the Assets Under Management (AUM) exceed the amount of €250 million, additional capital (0.02% of the amount exceeding €250 million) is expected to be required. If funds are internally managed then the minimal capital requirement may be increased to €300 million.
- The requirement for remuneration policies. The purpose is to encourage rigorous and effective risk management and to avoid risk-taking that would be inconsistent with the risk profile and rules of the managed AIF.
- The requirement for functional and hierarchical separation of an AIFM’s risk management function from its other functions, including that of portfolio management.
- Minimum requirements for systems and governance arrangements required of AIFMs. These arrangements include:
  - Consistency between risk profile and risk limits;
  - Periodic reporting to those tasked with governance;
  - Stress-testing; and
  - Sufficient and appropriate risk-monitoring systems.
- Stricter notification requirements on AIFMs intending to outsource some of its activities; thus, indirectly requiring more in-house operations.
- The requirement for AIFMs to set a maximum level of leverage for each AIF under management and to be able to demonstrate that the self-imposed leverage limits are adhered to for each AIF.
- The requirement for an AIFM to ensure that appropriate and consistent procedures are in place for the proper and independent valuation of the assets of each AIF under management.
- The requirement for AIFMs to make available certain information to investors before they invest in an AIF.
- The requirement AIFMs to ensure that a single depositary is appointed for each AIF it manages. Depositaries are expected to have to be domicile in the same country where the AIF is.
- The introduction of an “EU passport” allowing AIFMs who fall within the new regulations to market to professional investors in Member States.
- Certain marketing requirements for AIFMs. The Directive has tabled a number of proposals and these have been the heart of much debate. Several issues affecting the real estate fund management sector have been discussed at length. Some are listed on the next page.
The definition of “joint ventures,” and whether a
REITs (there is further
enhanced disclosure
management or by an independent valuer. It is
enhancement of real estate cross-border structures.
Solvency II
The Directive is intended to establish a new set of valuation techniques and governance, capital requirements, and reporting standards that will replace requirements from Solvency I. Solvency II applies to individual companies as well as insurance groups across the European Economic Area (EEA). It aims to implement solvency requirements that better reflect the risks companies face and deliver a supervisory system that is consistent across all EU member states. The Directive will shock test diverse asset classes to determine the necessary capital reserves for insurers. Depending on the perceive risk of the asset class, insurers will have to set aside reserves to ensure it can cover liabilities to policyholders if the value of the asset falls. Some of the expected aspects of the Directive are listed below:
• It will apply to insurance and reinsurance with gross premium income in excess of €5 million or gross technical provision in the excess of €25 million. Incentives, perhaps in the form of reduced capital requirements, to implement proper risk management systems and rigorous internal controls.
• A requirement for firms to disclose their capital and risk frameworks and to demonstrate how and where the requirements are embedded in their wider activities.
• That direct real estate investments must keep a 25% capital deposit ratio with no leverage, or 39% if leverage is used.
• A requirement for an internal model by which insurers calculate their capital requirements (a tailored model may also be used). The Directive has been structured around three pillars, with each pillar governing a different phase of the Solvency II requirements and approach. (See table below, left)
Some of the issues that have been debated relating to Solvency II are listed below:
• Whether real estate funds would be treated as transparent or opaque.
• If capital cost is likely to make insurers look more closely at their returns from investments.
• The issue of look-through; that is whether the calculation of the market shock should apply to the investment instrument in the portfolio or the underlying assets.
• In regards to property shocks, whether the 25% of capital requirement is too high and does not accurately reflect the pan-European volatility.
• Whether the high capital requirements that are charged against net asset value, may encourage insurance companies to invest in real estate funds with lower equity and higher leverage (generally a riskier strategy).
• Due to high capital requirements, during a falling property market, whether insurers will have to sell real estate at a discount to maintain adequate capital ratios in compliance.
• How REITs would be listed.
Solvency II’s impact not only the insurance industry but also the many sectors where they make investments. The new regulation is likely to change the way insurers approach investments and this will affect Real Estate Funds because even though real estate as an asset class represents a small portion of insurers’ balance sheet, there are over 90 insurance companies headquartered in Europe, managing over €35 billion, which invest in real estate.

Early in the 1970s, the Committee of European Insurance Regulators (CER) was established, it aims to ensure that insurers and reinsurers are adequately supervised. In 2012, the European Commission agreed with the European Parliament and the Council of the EU to ask for a technical assessment of the impact of Solvency II on insurance products with long-term guarantees. The technical specifications for the assessment are expected by the end of January 2014. However, some commentators believe that a timescale of 2015-17 may be more realistic. Solvency II was designed to add an extra layer of protection to the financial system. The new system of governance (demonstrating an adequate system of governance) Solvency II will require insurers to hold capital, which will be adjusted based on the insurer's risk profile and the insurer's ability to absorb losses in the event of extreme adverse events. The new solvency system will ensure that insurers have sufficient capital to meet their obligations to policyholders and to maintain their solvency. The implementation of Solvency II will have significant implications for the insurance industry, as it will require insurers to hold higher levels of capital, which will impact their profitability and the premiums they charge. The new solvency system will also provide a more comprehensive framework for risk management, ensuring that insurers can effectively monitor and manage their risk exposures. This will improve the quality of insurance products and services, leading to more stable and sustainable growth for the insurance industry. The Directive addresses issues related to the financial stability of the insurance sector and the protection of policyholders. It introduces a new set of requirements for insurers, including capital adequacy, risk management, and governance. The new solvency system will require insurers to hold higher levels of capital, which will impact their profitability and the premiums they charge. The new solvency system will also provide a more comprehensive framework for risk management, ensuring that insurers can effectively monitor and manage their risk exposures. This will improve the quality of insurance products and services, leading to more stable and sustainable growth for the insurance industry.

Basel III
Basel Accords are a series of recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. In 2004, Basel II was introduced in order to better regulate the banking industry and prevent a crisis in much. However, the credit crunch and following financial crisis indicated that capital measures adopted in Basel II were ineffective and did not prevent banks from going bankrupt. Basel III’s definition of capital did not only include common equity capital but hybrid stock that was illiquid and proved problematic to use in the event of severe write-downs. Counterparty risk was also a major issue. The collapse of the money market during the last quarter of 2008 proved that liquidity, a more strict definition of capital, counterparty risk and other issues related to the financial system had to be regulated. In response to the deficiencies in financial regulation revealed in the late 2000s financial crisis, the third of the Basel Accords was developed.

Based on the Solvency II work, the goal of Basel III was to ensure that banks could withstand a single large shock to their balance sheets. The key principles of Basel III are: ensuring banks have adequate capital to absorb losses in the event of losses, ensuring banks’ ability to operate during a financial crisis, and ensuring banks are not only required to hold enough capital, but also that the capital is of high quality. Basel III contains a number of key elements, including:

• New capital requirements: The Basel III capital requirements are divided into two tiers. Tier 1 capital is made up of common equity, the most stable and liquid form of capital. Tier 2 capital includes hybrid securities and other capital instruments that are less liquid. The new Basel III capital requirements were developed to ensure that banks have sufficient capital to withstand shocks and maintain solvency. The new requirements are based on the recommendations of the Basel Committee on Banking Supervision and are designed to reduce systemic risk and ensure the stability of the financial system.

• Net Stable Funding Ratio: Basel III introduces a new ratio called the Net Stable Funding Ratio (NSFR) to ensure that banks have access to stable funding to support their business activities. The NSFR measures the percentage of funding that is derived from stable funding sources over a one-year horizon. The ratio is intended to ensure that banks have access to funds that are not subject to market pressures, such as deposits from wholesale markets, and that they can meet their funding needs in times of stress.

• Liquidity Coverage Ratio: Basel III introduces a new liquidity ratio called the Liquidity Coverage Ratio (LCR) to measure the amount of liquid assets that banks have available to meet their short-term funding needs. The LCR measures the ratio of a bank’s liquid assets to its short-term liabilities, and is intended to ensure that banks can meet their short-term funding needs in times of stress.

• Total Loss-absorbing Capacity: Basel III introduces a new metric called the Total Loss-absorbing Capacity (TLAC) to measure the ability of a bank to absorb losses in the event of a crisis. The TLAC measure is intended to ensure that banks are able to absorb losses and maintain solvency in times of stress.

• Balance Sheet Leverage Ratio: Basel III introduces a new leverage ratio to measure the amount of leverage that banks are using in their business activities. The leverage ratio measures the ratio of a bank’s total assets to its Tier 1 capital, and is intended to ensure that banks are not using too much leverage in their business activities.

• Capital Buffer: Basel III introduces a new capital buffer to ensure that banks have sufficient capital to withstand shocks and maintain solvency. The capital buffer is intended to ensure that banks have sufficient capital to withstand losses in the event of losses, and to ensure that banks can meet their funding needs in times of stress.

• Stress Test: Basel III introduces a new stress test to ensure that banks have sufficient capital to withstand shocks and maintain solvency. The stress test is intended to ensure that banks can maintain solvency in times of stress.

• Overall Improvement: Basel III is designed to improve the overall resilience of the banking system and to ensure that banks are better able to withstand shocks and maintain solvency. The new requirements are intended to reduce the risk of systemic risk and to promote the stability of the financial system.

• Summary of proposed changes in Basel III

**FIRST**
Increase the quality, consistency, and transparency of the capital base
- Tier 1 capital: predominant form of capital must be common shares and retained earnings
- Tier 2 capital instruments will be harmonized
- Tier 3 capital will be eliminated

**SECOND**
Strengthening of risk coverage of capital framework
- Add the Credit Valuation Adjustment-risk due to deterioration in counterparties’ credit rating
- Promote more integrated management of market and counterparty credit risks
- Provide incentives to strengthen the risk management of counterparty credit exposures
- Raise the capital buffers backing these exposures
- Reduce procyclicality

**THIRD**
Definition of a leverage ratio as a supplementary measure to the Basel II risk-based framework
- Introduction of a leverage ratio requirement with the following objectives:
  - Introduce additional safeguards against model risk and measurement error
  - Put a floor under the build-up of leverage in the banking sector

**FOURTH**
A series of measures to promote the build-up of capital buffers in good times that can be drawn upon in periods of stress
- Measures to address procyclicality
  - Promote more forward-looking provisions
  - Ramp up any excess cyclically of the minimum capital requirement
- Achieve the broader macro prudential goal of protecting the banking sector from periods of excess credit growth
  - Improve calibration of risk functions
  - Conduct stress tests that include widening credit spreads
  - Use long term data horizons to estimate probabilities of default

**FIFTH**
Introduction of a global minimum liquidity standard for internationally active banks
- Net Stable Funding Ratio
- Review of need for additional capital, liquidity or other supervisory measures to reduce the externalities created by systematically important institutions

**Summary of Basel III**
Basel III is a set of international standards for banking supervision that was developed by the Basel Committee on Banking Supervision. The main goal of Basel III is to strengthen the resilience of the global financial system and to reduce the risk of systemic risk. Basel III is based on the principles outlined in Basel II, but it includes several new requirements to address the weaknesses identified in the financial crisis of 2007-2009. Some of the key elements of Basel III are:

- **Tier 1 capital** must be common equity and Tier 2 capital must be subordinated debt and other forms of capital with more limited adequacy. Basel III requires banks to hold a minimum of 4.5% Tier 1 capital and 8% total capital (Tier 1 and Tier 2 capital combined).

- **Net Stable Funding Ratio** (NSFR) must be at least 100% to ensure that banks have access to stable funding to support their business activities. The NSFR measures the percentage of funding that is derived from stable funding sources over a one-year horizon.

- **Liquidity Coverage Ratio** (LCR) must be at least 100% to ensure that banks have access to liquid assets to meet their short-term funding needs. The LCR measures the ratio of a bank’s liquid assets to its short-term liabilities.

- **Total Loss-absorbing Capacity** (TLAC) must be at least 10% to ensure that banks can absorb losses and maintain solvency in times of stress.

- **Balance Sheet Leverage Ratio** must be at least 3.5% to ensure that banks are not using too much leverage in their business activities.

- **Capital Buffer** must be at least 2.5% to ensure that banks have sufficient capital to withstand shocks and maintain solvency.

Basel III is a significant improvement over Basel II, but it is not without controversy. Some critics argue that the new requirements are too onerous and will lead to lower bank profits and reduced lending. Others argue that the new requirements are too lenient and will not be effective in reducing the risk of systemic risk. Despite these concerns, Basel III is widely seen as an important step forward in improving the resilience of the global financial system.
It is certain that Basel III will not solve all the financial problems and there is still a long way to go. In regards to Basel III’s treatment of real estate, we are still waiting for a clearer framework to be published. However, the information made available so far provides us with some ideas about the likely consequences for the industry and the measures to be adopted. Institutions must, therefore, retain flexibility to accommodate years of modification and future reforms; and even though Basel III is not expected to have been fully implemented much before the 2019 deadline, institutions that will be affected by Basel III should execute changes at a much earlier stage.

European Market Infrastructure Regulation (EMIR)
The default of Lehman Brothers, the collapse of Bear Sterns, and the bailout of AIG highlighted the problems with the Over-The-Counter (OTC) derivatives market during the financial crisis of 2008. In response to these problems, there has been a global effort to increase stability in the financial market. In September of 2009 leaders of the G20 countries introduced new regulations in charge of supervising all standardized OTC derivative contracts. In September of 2010 a final proposal was published and later reviewed by the European Council and Parliament who named the new European regulation on OTC derivatives “European Market Infrastructure Regulation” (EMIR). EMIR is expected to implement the G20 commitment to have all standardized OTC derivatives cleared through a central counterparty in the EU in early 2013. This is an effort to decrease operational and counterparty risk in the OTC derivatives market to avoid future financial crises. The purpose of EMIR is to increase market stability and to decrease market interdependencies. The Directive will introduce a clearing obligation for eligible OTC derivatives, a reporting obligation for OTC derivatives, measures to decrease counterparty credit risk and operational risk for bilaterally cleared OTC derivatives, common rules on the establishment of interoperability between Central Counterparties (CCPs), and rules for CCPs and trade repositories.

There are many other regulations that will affect the real estate investment fund sector. While the impact of these regulations may not be as great, it is important to be aware of them and their implications.

Some of the key aspects are listed below:

- Risk will be reduced by requiring financial counterparties to clear all eligible OTC derivatives with a central counterparty.
- Financial counterparties are defined as including investment firms, insurers, credit institutions, AIFMs and undertakings for collective investment in transferable securities (UCITS).
- Put in place certain risk management procedures for OTC derivatives transactions that are not cleared.
- Increase transparency through reporting of trades in OTC derivatives in the EU to central data centers.
- EU regulators will have access to repositories, allowing them to have a better overview of what is owed and to whom. This will help detect, in advance, possible problems such as accumulation of risk.
- Some basic issues identified in EMIR are strict collateral requirements, increased or additional clearing fees and new reporting obligations, possible liquidity drains in the real estate sector, requirement to set aside deposits to cover out of the money positions on derivatives contracts, and technology and operations challenges.

Other regulations
There are many other regulations that will affect the real estate investment fund sector. While the impact of these regulations may not be as great as the impact from regulations previously mentioned, it is important to be aware of them and their implications.

In the US, there are two regulations whose effect will extend to European real estate funds: the Foreign Account Tax Compliance Act (FATCA) and the Dodd-Frank Act.

The purpose of FATCA is to ensure the disclosure of offshore accounts, investments, and income of US persons by requiring certain entities to disclose to the Internal Revenue Service (IRS) information about US account holders. This regulation is principally trying to tighten sanctions against offshore tax abuse. The regulation imposes a complex withholding and reporting rule for payments to Foreign Financial Institutions (FFIs). The definition of FFIs is very broad and will include foreign banks, broker-dealer institutions, funds, and more.

The Dodd-Frank Act repeats international regulatory proposals, limiting risk in the financial system, and regulating the unregulated. The regulation places a significant emphasis on the oversight of systematically important institutions by creating a regulatory framework for such institutions. In both the US and the EU, being designated as systemic could result in increased supervisory intrusion, higher capital and liquidity standards, the potential to see limits imposed on business activity and expansion, and requirements to maintain capital.

Similar to the requirements of Basel III, the Dodd-Frank Act repeats international regulatory pronouncements by calling for all financial institutions to hold more and better quality capital. All of these measures will eventually result in higher capital costs of doing business for most financial institutions. Also, as a result of the regulations, many fund advisors with more than US $100 million in Assets Under Management (AUM) may be required to register with the Security and Exchange Commission (SEC) and will be subject to SEC regulatory oversight. Advisors to real estate funds will only be required to register if their investment strategies cause them to fall under the definition of an “investment advisor.”

There are other environmental and sustainability regulations that may eventually have a significant impact in the real estate fund management decision making process. With the entire world moving to more environmentally friendly standards, regulations that will affect managers’ asset selection processes are currently being developed. Real estate fund managers will need to be ready to confront such changes.

FATCA encourages compliance by imposing a disciplinary 30% withholding tax on certain US-sourced income, as well as on the gross proceeds from the disposal of certain investments, regardless of whether there is any gain. For this reason, FFIs will have to make strategic decision either to establish a US compliant business model or be able to demonstrate full exit from US client relationships.

On the other hand, the Dodd-Frank Act is focused on three broad outcomes: increasing consumer protections, limiting risk in the financial system, and regulating the unregulated.
The Dodd Frank Act may significantly affect the cost and availability of funding and financial products, and its impact may stretch far outside the USA.

Impact Analysis

While some regulations are directed to investors and depositaries – such as insurers and banks – and not to investment funds directly, real estate fund clients’ compliance requirements will have a direct impact in the way real estate funds currently operate. Here we will analyze how these regulations impact the real estate fund industry.

Complying with the new regulations is more than simply a technical regulatory exercise. Large compliance projects will be needed and they will have wide-ranging impacts on a fund’s staff and business beyond the risk management, systems and processes, and compliance and finance functions. The complexity of the impact in each real estate fund will depend on several factors such as the flexibility of source systems, the number of countries in which a fund operates, the level of communication between departments and the number of other strategic initiatives competing for budget and resources.

Overall, these regulations will require significant modifications to the structure, operations and strategies of real estate funds and fund managers, especially in reorganization of business models currently in place and reorganization of funds as funds and managers will migrate to more favored locations. Many real estate managers will face increased capital requirements; thus more specific monitoring procedures will need to be adopted in order to attract investors and comply with certain regulations. There may be a significant increase in the use of resources needed for the administration of real estate funds, as managers will be required to improve their risk management systems and reporting practices, change depositories, utilize independent valuation and custodian services, and much more. This may result in an increase in fees charged to investors, reducing the attractiveness of investing on real estate funds. This has resulted in a growing focus on the cost and efficiency of fund administration and may lead to some real estate funds consolidation in the market.

Major investors will also face stronger regulations and capital requirements tempting them to consider withdrawing from some markets. For some investors, such as insurers, the regulations will push them to reconsider their investment strategies since the capital cost of investing in real estate relative to other asset classes will be greater; thus, encouraging insurers to delay deploying capital with real estate managers. Also, banks are likely to see a significant hit to their margins; as a result, they will have to restrict lending on illiquid assets such as commercial property, adding to the already complex reality real estate funds and fund managers will have to face.

Now we will take a look at how some of the regulations mentioned above will individually impact the real estate fund industry:

**AIFMD**

The Alternative Investment Fund Manager Directive is the regulation that most directly affects real estate funds and fund managers. The Directive will impact several areas of funds business processes such as investment management, asset

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**AIFMD EU-based platforms**

- Strategic implications will flow from multiple “managers” of AIFs and AIFs within a typical structure, as well as the cost of complying with depositary, reporting, authorization and risk management requirements.
- Relationships with service providers will need to be reviewed, as will internal segregation of functions.
- Ramification of key personnel will need reviewing to align interest with fund strategy.
- Formalization of the risk and liquidity management function will be time-consuming, but has high notional value to investors.
- Each AIF requires a depository which must be either an authorized credit institution, an authorized investment firm, or another institution subject to prudential regulation. This represents a significant incremental cost.
- AIFMs need to develop and implement customized reporting templates at AIFM and AIF levels.

**AIFMD non EU-based platforms**

- Non-EU AIFMs intending to market AIFs they manage in the EU using a passport must acquire prior authorization from their member state of reference.
- This will require full compliance with the Directive or equivalent standards, as well as additional conditions relating to cooperation arrangements, tax information-sharing, anti-money laundering provisions, and the nomination of a legal representative to act as a single point of contact within the EU.

While some regulations are directed to investors and depositaries – such as insurers and banks – and not to investment funds directly, real estate fund clients’ compliance requirements will have a direct impact in the way real estate funds currently operate. Here we will analyze how these regulations impact the real estate fund industry.

Complying with the new regulations is more than simply a technical regulatory exercise. Large compliance projects will be needed and they will have wide-ranging impacts on a fund’s staff and business beyond the risk management, systems and processes, and compliance and finance functions. The complexity of the impact in each real estate fund will depend on several factors such as the flexibility of source systems, the number of countries in which a fund operates, the level of communication between departments and the number of other strategic initiatives competing for budget and resources.

Overall, these regulations will require significant modifications to the structure, operations and strategies of real estate funds and fund managers, especially in reorganization of business models currently in place and reorganization of funds as funds and managers will migrate to more favored locations. Many real estate managers will face increased capital requirements; thus more specific monitoring procedures will need to be adopted in order to attract investors and comply with certain regulations. There may be a significant increase in the use of resources needed for the administration of real estate funds, as managers will be required to improve their risk management systems and reporting practices, change depositories, utilize independent valuation and custodian services, and much more. This may result in an increase in fees charged to investors, reducing the attractiveness of investing on real estate funds. This has resulted in a growing focus on the cost and efficiency of fund administration and may lead to some real estate funds consolidation in the market.

Major investors will also face stronger regulations and capital requirements tempting them to consider withdrawing from some markets. For some investors, such as insurers, the regulations will push them to reconsider their investment strategies since the capital cost of investing in real estate relative to other asset classes will be greater; thus, encouraging insurers to delay deploying capital with real estate managers. Also, banks are likely to see a significant hit to their margins; as a result, they will have to restrict lending on illiquid assets such as commercial property, adding to the already complex reality real estate funds and fund managers will have to face.

Now we will take a look at how some of the regulations mentioned above will individually impact the real estate fund industry.

**AIFMD**

The Alternative Investment Fund Manager Directive is the regulation that most directly affects real estate funds and fund managers. The Directive will impact several areas of funds business processes such as investment management, asset...
Managing Risks in the evolving world of Real Estate

management, risk management, fund structure, marketing and sales strategy, depositary and capital requirements, valuation, delegation and outsourcing, monitoring, disclosure and reporting, and remuneration.

• Risk management provision and independence – the risk management function will have to be separated from operations thus representing a challenge since the management of the firm and the management of the funds are overlapped.
• Fund structure and marketing – EU AIFMs through an onshore passport will have an entrance distribution route in Europe. However, non-EU AIFMs will rely on country by country agreements and starting in 2015 they will require a special passport in order to market their funds. These will force real estate funds to analyze alternative business models and assess their strategy, including re-domiciliation of fund managers.
• Depository – Fund managers will have to appoint a single depositary that will be liable to the fund and its investors. The depositary will be responsible for all assets and any consequential losses to investors. Depositaries will need to revise their current set up, develop and adapt their procedures and systems, and existing agreements may need to be redrafted since the requirement and rules of the Directive varies from existing ones. This will lead depositaries to challenge AIFMs on key risk areas, increasing contractual complexities and higher fees.
• Valuation – Valuations for open and closed-ended funds will have to be done more frequently (ad-hoc valuations) and since real estate funds use internal quarterly or semi-annual valuations, managers will have to consider the need to segregate their valuation function.
• Management, delegation and outsourcing – Under the Directive, managers will be able to delegate functions such as risk or portfolio management to authorized asset managers as long as they are in compliance with regulations (especially if asset managers are in third countries). In practice, this will require some restructuring, specifically in the case of non-authorized or non-EU asset managers.

Solvency II
This regulation will reshape product development and pricing, hedging and reinsurance strategies, and underwriting and investment management; thus, having a major impact on the way in which European life insurance companies and defined benefit pension schemes consider real estate as an asset class. Solvency II will impact the capital cost of investing in real estate and most of the real estate industry has now focused its attention on the amount of capital, which insurers must hold to cover a possible fall in the value of their real estate investment assets under the standard formula. Also, another concern for the real estate fund industry is how insurers will treat real estate as an asset class in their own internally generated models.

Fund managers will also need to address the reporting implications under Solvency II. It is expected that funds will be treated as transparent so reporting will need to be at the level of the underlying investments of the funds. Insurers will have to prove to regulatory bodies that the data they use is complete, accurate and appropriate; for that reason, asset managers will need to meet the same standards of quality. However, this is an area of uncertainty that is encouraging insurers to postpone the deployment of capital with real estate fund managers.

Given that the legislation will require insurance companies to significantly increase their capital reserves when investing in risky assets, it is anticipated that there will be a resulting impact on insurance companies’ allocation to the real estate sector – the most likely result being more direct investments or becoming a lender to the industry.

Basel III
It is believed by industry experts that the measures banks may take to tackle regulatory and macro-economic pressures may have a major impact in real estate financing. Deleveraging may not free up capital for fresh property lending, debt may become more short-term and expensive, and the need to find alternative sources of funding may become imperative. Since there is a strong emphasis on liquidity, assets that are seen as more liquid may command a higher risk weight pushing banks to put aside more common equity for such assets. This means that lending on other illiquid assets such as commercial property may be more restricted.

In regards to real estate lending, banks may prefer to finance the most liquid project of real estate; therefore, larger markets such as Germany, France and the UK will enjoy better lending activity compared to other smaller markets. So in order for more illiquid real estate markets to maintain their trading level new forms of financing – perhaps through capital markets – will need to arise.

Alltogether, Basel III will move Europe towards a more American model of financing.

Impact of Basel III on real estate

• The biggest banks are expected to unbundle real estate.
• Banks will return to what are judged to be core markets or sectors.
• Most real estate lending outside the home country will be deemed non-core.
• Where real estate is wholly or partially owned by banks, they will seek to sell the assets wherever there is a minimal impact on the balance sheet.
• Liquidity risk, stress testing and reporting are a huge change for many banks.
• The changes may pose strategic challenges for some banks because as the cost of capital increases, some business models may no longer be profitable. The cost of borrowing for real estate (and other) companies will increase.
Managing Risks in the evolving world of Real Estate

Impact of EMIR on real estate

- For real estate funds, it will focus on instruments used to manage risk, such as interest rate swaps on property borrowings (either for reasons of prudence or as required by lenders).
- EMIR will require swap activities to be cleared through exchanges, rather than be handled as they are now – over the counter.
- Another aspect is the mark-to-market requirement on all positions regularly and the requirement to post collateral in connection with negative-valuation movements.
- The cash collateral that will need to be posted in a margin account will have to sit on the sidelines un-invested. This will most likely come from calling down capital from investors.

Impact of Dodd-Frank on real estate

- May have a material impact on an organization’s operational and compliance requirements and processes.
- It enhances the powers of the SEC and provides improved whistleblower protection.
- Registered advisors will need to:
  - Designate a chief compliance officer.
  - Establish and maintain a compliance program intended to prevent violations of law and regulation.
  - Develop comprehensive written compliance policies and procedures.
  - Conduct annual assessments of the adequacy of the compliance program.
  - Dodd-Frank has real significance for non-US financial companies (including real estate private equity funds) doing business in the US.
- Non-US firms that do need to register as advisors face a number of practical challenges and will become subject to the US Investment Advisers Act, which is based on the concept of fiduciary duty.
- They will need to file Form ADV with the SEC, both on initial registration and annually.
- They will need to disclose the firm’s disciplinary history and any conflicts of interest.
- They will be expected to maintain books and records for inspection – including financial records, client transactions and advisory agreements.
- They will also need data on value and type of assets under management, counterparty credit risk, the use of leverage, valuation policies and practices, trading practices and positions and the use of side pockets.
- Once registered, a non-US firm will be subject to examination and oversight by the SEC.

Drivers for change

There is a need for real estate funds to develop and introduce new and specific systems and procedures which could be very costly if not done the right way or perhaps if done too late.

Fund managers will need to make sure that the necessary investment in business processes and operational functions required to comply with new regulations is carefully scoped, planned, communicated with investors, and executed within the next 12 to 24 months.

However, introducing new systems will be complex and costly and such an increase in cost is putting a lot of pressure on real estate investment platforms to figure out ways to be more efficient. For this reason managers will have to start developing and implementing new business processes designed to help them manage (reduce) cost, improve performance, and comply with new regulations as early as possible.

From the regulations described previously, there are four major common areas where managers will have to make changes: risk management practices, transparency, capital requirements/ratio calculations, and investment strategies. Adopting a system that will combine the points below will not only facilitate managers to comply with the new regulations, but also help them reduce and manage cost in the mid to long run. Overall, these new business processes will provide a significant competitive advantage to those who implement them, especially those who start earlier as they will able to better anticipate possible risks. Below we will present possible processes for each area.

Risk management

Real estate managers will need to reshape the way they currently manage their risk. Traditionally,
Managers adopt a more calculating position instead of a more anticipatory position. They need to better anticipate the risk occurring in their portfolios and move from a descriptive to a more predictive manner and present it in an easy-to-follow format. A well-structured reporting process should have the following characteristics:

- Rapidly generate multiple reports across multiple periods.
- Easily shareable with investors, other stakeholders, and regulators.
- Support multiple formats.
- Integration with different accounting and asset management systems.
- Report KPIs at every stage of the investment lifecycle.
- Show comparison between initial position and outcomes.
- Focus on value analysis.
- Capabilities of processing large quantity of data.
- Financial reporting: Report on activities and Disclosures to investors.
- Reporting in an understandable manner.

As part of their current business processes, managers should develop ways of running multiple and complex calculations of capital ratios through internal or tailored models. Successful managers will follow a process that will test worst case scenarios to help them maintain adequate capital ratios. These calculations need to reflect the correct volatility in order to secure greater levels of leverage and assure solvency and liquidity in case of future downturns.

Business processes should integrate multiple data and be able to quickly calculate the following typical ratios (not exhaustive):

- Leverage ratios
- Liquidity ratios
- Current ratio
- Quick ratio
- Cash ratio
- Cash conversion cycle
- Profitability ratios
- Solvency ratios
- Value ratios

Managers must identify the key areas in need of change of their business model and make the proper changes as early as possible in order to gain competitive advantage. While many of these vehicles will present pros and cons, OPICs are possibly the vehicle that most closely aligns to the current and future regulatory requirements since they address the most of the risk management, transparency, and ratio requirements imposed by the AIFMD, SOLVENCY II, BASEL III, and EMIR.

Over all, in order to comply with regulations and to gain a significant competitive advantage, managers need to start making changes in their current business processes. The suggestions above, while perhaps the most needed, are only a few from a set of new processes that will need to be adopted by AIFMs as the demand for change will be greater. While regulations are usually seen as challenges, they also represent a great opportunity, and in order to fully take advantage of such, the industry will need to go from a calculating position, based on past performance, to an anticipating position. Now more than ever there is a greater need to anticipate consequences of risk occurring in portfolios; so forecasting future trends and moving from descriptive tools towards more predictive analytical tools will make the difference between failure and success.

Conclusion

The past five years have proven to be very damaging to the global economy. Financial instability and investors’ demands have driven governments around the world to develop and impose regulations on the alternative investment fund industry. Passage of the AIFMD and EMIR in Europe, and the Dodd-Frank act in the US, will have a direct impact on real estate investment managers. On the other hand, Basel III and Solvency II in Europe, and FATCA in the US, will impact capital flows. These regulations are driving substantial change across many sectors of the alternative investment industry; real estate being one of the most affected, enduring some fundamental structural changes. Real estate funds will require a significant change of the current business models in order to comply with regulations and meet investors’ demands. However, no challenge comes without an opportunity and the impact of these regulations on real estate funds can result in significant benefits to many fund managers.

Managers must identify the key areas in need of change of their business model and make the proper changes as early as possible in order to gain competitive advantage.
Preparing for change: Making your business fit for the new regulatory environment

Taliance analyses how complying with the new regulations will be much easier for companies that improve their data management systems.

You’ve got a first-class fund management team, great clients and promising funds. Your company has built an enviable reputation for business integrity, and its professionalism should mean it sails through any regulation it can throw at it. So, why risk failing foul of regulation just because your systems are simply not up to the job?

A decade ago it was acceptable to run a real estate investment business using a system that was little more than a collection of spreadsheets fluttering slowly from one department to the next. Business was good; regulation far from onerous, and everyone was comfortable with spreadsheets, so why not?

Fast forward ten years and not only are we still suffering the economic chill from 2008, there is now a cold front heading our way in the form of regulation. AIFMD, Solvency II, Basel III, EMIR, FATCA and Dodd-Frank all have their own defining characteristics, but they are unified by the drive to provide investors, and other stakeholders, with better shock testing, security, analysis and transparency.

Up-to-date reporting based on a firm foundation of credible data will soon be a necessity and, frankly, spreadsheets are not going to cut it. Here’s why.

Internal controlling and data security

No systems are completely secure, but some are inherently better than others. Spreadsheets are very secure if used by just one or two people, but at an enterprise level protection is woefully inadequate.

"Other than basic password restrictions, you have very little control over who opens your spreadsheets and what changes they make," said Guillaume Faistie, CEO Taliance. "The risk here is to alter data without anyone knowing it."

By using a centralised data management system, administrators can set account privileges to give users different levels of access. People, even external clients, are able to see and do exactly what they are supposed to. No more, no less.

Speed of data acquisition

Typically, property managers input data into spreadsheets before sending them up to asset managers, fund managers and other levels of management. At each stage, versions are also distributed sideways for more data to be added, amended or removed before being consolidated again and sent onwards and upwards.

The opportunities for re-keying, and mis-keying, are huge and, because of all these changes, it can take weeks for the data to flow from a property manager’s spreadsheet to an investor report – by which time it is already out-of-date.

"With a centralised database system, you are always connected to underlying data," said Guillaume. "Just by pressing a button you get the latest set of data instantly, and you can pass it up to the next level without having anything to rekey or recheck."

"If you are using a third party to supply property management services, it is straightforward to connect their data source to yours. Structured data in a single database is the goal – one that is impossible to score with spreadsheets."

Auditability

The threat of mis-keying whilst re-keying data into a spreadsheet is very high. The re-keying of data is always a messy environment – it is a last resort, and not a task that people relish. But, it is a common process with spreadsheets and pdfs, because the data is not structured, making it impossible for figures to flow easily from one file to the next.

With a centralised database system, data is only ever keyed once.

Managing formulas can be a headache in Excel too: “Imagine a scenario where a spreadsheet has been authored with great intentions, before being passed around a workgroup for revisions,” said Guillaume. "At some stage, somebody within the group, elects to ‘improve’ one of the formulas but neglects to tell their colleagues. At this point you have a variety of different spreadsheet calculating, based on a variety of formulas."

"A worse problem with spreadsheets is that it is impossible to tell when elements have been updated," said Guillaume. "So when you are looking at a Financial Report or P&L in Excel, you don’t know whether changes were last made yesterday, or the month before." Unlike centralised database systems, spreadsheets have no reliable method of versioning, but upcoming regulation – in particular AIFMD – will make the tracking of changes mandatory.

Conversely, with a centralised system users always have the most up-to-date version of models and formulas at their fingertips. Changes are dynamic, so when one person makes an alteration every other user is able to see what they have done and the impact of their changes. Such a system not only makes it easier to comply with the demands of regulation, it also simplifies the nuts-and-bolts of real estate management and frees fund managers from administrative tasks to focus more on creating value for their clients.

The right tool for the job

The humble spreadsheet has gained popularity because it can be tailored to a thousand different uses. One of these uses is data modelling, but it is important to understand that spreadsheets have not been developed specifically for this task. Instead, you need to use a tool dedicated to modelling.

For example, spreadsheets do not provide any dimension around time, which is a significant handicap. "Financial modelling is assessing how parameters will evolve over time," says Guillaume. "And the notion of time does not exist in Excel. So, for example, when you refer to April 2015 in Excel you have to remember that there is a value for it somewhere in column L."

The use of spreadsheets in the real estate industry is widespread, but with new regulations on the horizon shrewd asset managers and fund managers are now seeing their deficiencies as a threat. A centralised database system will enable companies to comply with regulation with the least amount of disruption, and Taliance is well placed to provide them with a solution that will help them achieve this.
Taking control: Is there a pilot in the cockpit?

Prove to investors that you are really in control of your funds, and the regulations could be a blessing in disguise.

It can be hard to see the upside of regulation if you are the one under the regulator’s relentless, all-seeing, all-knowing gaze. But astute fund managers will keep, and instead recognise that the new regulations herald an era of opportunity.

The regulations will require more sophisticated risk management strategies and greater transparency. Real estate fund managers will have to broadcast an extensive level of information to institutional investors, and for many this will be a big issue. For example, the AIFMD will oblige fund managers to compare any future plans for a fund with its original inception plan. All decisions that have been made from the fund’s inception plan will have to be tracked, reported and justified. Fund managers can no longer claim that a judgment was, or should be, made on gut instinct alone.

Agile decision making

The problem is that fund managers can make up to hundreds of decisions every day. The best are those who consistently make the right decisions fastest. And, as the market grows more competitive, so does the pressure to be decisive. The penalties for reacting too slowly to the market can be severe. During the early stages of the financial crisis, the only way of accelerating the decision making process was to crash and burn,” said Guillaume. “Everyone will be able to audit all of the decisions that have been made, as well as the data on which they were based.”

Frankly, if you deploy money now and choose the wrong manager, then you will probably lose your job. So, people have to make the right decisions, and they have to show that they have learned from previous mistakes.

“For fund managers, having proper systems, rigorous procedures and good alignment are critical, so that they can gain the trust of investors by impressing them with accurate forecasts and reports. Everybody should be making educated, well informed decisions, and the people handling investors’ money should have the systems and processes in place to handle it well. When confidence does return to the real estate market, it is only natural that investors will choose to place money with those fund managers who can prove they have risk under control. “They want to make sure that somebody is in the cockpit,” said Andrew Thornton, Chief Executive Officer, of Internos Global Investors.

For fund managers, having proper systems, rigorous procedures and good alignment are critical, so that they can gain the trust of investors by impressing them with accurate forecasts and reports.

Andrew Thornton, Chief Executive Officer, of Internos Global Investors
The raft of new regulations affecting the real estate investment industry seem to promise fund managers a future working environment that is increasingly complex and governed by demands that will test their time and resources to the limit.

In such a landscape it would be easy to think that only the largest businesses – those with the means to meet the challenges of the new regulatory environment – will prosper. However, according to Andrew Thornton, Chief Executive Officer, Internos Global Investors, the future will belong to those companies who, regardless of their size, can continue to meet their investors’ requirements.

“I think we’re in a pretty simple business as fund managers,” he said. “We have to understand the objectives of our investors, and match them with the opportunities that exist in our markets. For any fund manager to survive, big or small, they’ve got to show how they will create value, how they’re going to manufacture returns for the investors, and they’ve got to be able to do that in a safe, well-structured way. “Some people will say it’s easier for large organisations to fulfil these needs because they have the back-of-house, the IT systems, the compliance teams, and all that sort of thing.

“To some extent that’s true, but sometimes the red tape in large organisations can make it difficult for them to respond appropriately. This is particularly true for an asset class like real estate, where you don’t neatly sit in the same box as the equities or fixed incomes guys.

“Larger players operate under a swathe of different regulations, and they are always accessing different clients, so it’s as easy to underestimate the challenges facing the large firms as it is to overestimate the challenges facing local specialists.

“I definitely think there are roles for local specialists going forward, and I think you’ll see more joint ventures, and people learning up in different ways in the future.”

The need for more collaborative ways of working is likely to become even more critical in years to come if, as many real estate professional speculative, additional regulations follow those currently impacting the industry.

“We already have a lot of regulation in the US and Europe, and it’s likely that we will have even more in the future,” said Guillaume Faistre, CEO of Taliance.

“Governments want to rebuild investor trust in the real estate industry, and they see regulation as the only way to keep control and encourage investors.”

Whether regulators become increasingly active or not, Andrew warned against the dangers of over regulation.

“If both Europe and the US end up with a whole swathe of regulations, each building potential barriers of entry to the other, it could stop the What will the real estate investment industry look like when the new regulations have taken affect? Will there be further regulation in future? Here, we get an insider’s viewpoint on the new regulations, the implications for operators, and their thoughts on what the future may hold for the real estate investment market.
The market needs international cooperation and consistency to ensure that opportunities remain open and available in the future.

easy flow of capital from Europe to the US, and vice versa,” he said. “Some regulations might be meant to protect investors, but if it means they’re not able to access attractive investment opportunities in other parts of the world, what good does that do? I don’t think anyone wants a situation where different world regions aren’t able to work with each other. Instead, we need international cooperation and consistency to ensure that opportunities remain open and available in the future.”

The uncertainty over what regulators may do in future makes it imperative for fund managers to build flexibility into their IT solutions and business processes, according to Guillaume. In his view, rigidly sticking to processes through habit or a lack of awareness of the more sophisticated options available, will lead to managers becoming unstuck if future developments threaten to radically alter the way they work. “Whether you’re a big, multi-national business or a local specialist, you’ve got to have the flexibility and capacity to cope with whatever regulators throw at the industry in future,” he said. “This is especially true when you’re a big player, because the challenges you face are multiplied. The more countries you operate in, the greater the complexity from having to work with things like new regulations, different currencies, and local partners. And with greater complexity comes a need for even greater flexibility. “It’s for this reason that we are always developing our products to ensure they can connect to multiple underlying systems.” Andrew agreed that the right IT solutions, properly implemented and integrated, could benefit real estate investment businesses regardless of their size. “If you’ve got one fund and bright people, you can have a black box solution. If you have a big business and you want to know you have consistency of data, that you’re managing the risks properly, systems are a good thing,” he said. Andrew added that fund managers should seek out those systems that enhance and enable the skills of their workforce. “We don’t want to lose people’s real intuition and knowledge of funds. What we want is the best of both worlds,” he said. “We need the understanding and analytical processing that talented people bring to the industry, and we also need the consistency of approach and advanced data capture and risk management tools offered by sophisticated solutions.” Andrew agreed that the right IT solutions, properly implemented and integrated, could benefit real estate investment businesses regardless of their size. “If you’ve got one fund and bright people, you can have a black box solution. If you have a big business and you want to know you have consistency of data, that you’re managing the risks properly, systems are a good thing,” he said. Andrew added that fund managers should seek out those systems that enhance and enable the skills of their workforce. “We don’t want to lose people’s real intuition and knowledge of funds. What we want is the best of both worlds,” he said. “We need the understanding and analytical processing that talented people bring to the industry, and we also need the consistency of approach and advanced data capture and risk management tools offered by sophisticated solutions.” "I think both will play a part an important role in the future, and I think both should co-exist."
Taliance

One of Europe’s leading developers of IT solutions for the real estate investment market, Taliance provides the industry’s top professionals with outstanding support and high-performance software.

A proactive company with an incredible depth of experience gained from working with some of the real estate’s major players, Taliance specialises in developing innovative solutions for clients that respond to both today’s and tomorrow’s market developments.

The company has brought major advances to the market, such as the integration of asset management in IT systems, and the creation of a data protocol for legal and property data. Its Global Fund and FinAsset solutions are revolutionising the way real estate professionals work.

Taliance has won and retained some of the most dynamic clients in the market, including AEW Europe, Amundi Real Estate, AVIVA Investors, AXA REIM, BNP Paribas Real Estate, HSBC, Internos Real Investors and Captiva Capital Management.

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RealFoundations

RealFoundations is a global management consultancy focused on helping companies in the real estate industry improve their operations and achieve their potential.

It was founded in 2000 after concluding that the real estate industry was being poorly served by the big consulting firms. Since the founders and executive team of RealFoundations have years of experience working for those big firms, it also shared a great deal of frustration at the lack of importance placed on deep industry content knowledge.

The company believes that value can best be delivered by management consultants who understand your business, the market dynamics that drive it, the winning strategies and ideas that have been proven in your industry, and the most cutting-edge technology solutions that can help unleash your potential. RealFoundations understands that consultants are hired to make something happen — to facilitate change within your business and recognizing the importance of accelerating the time it takes to get from ideas to results.

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