Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Macroprudential Policy for the Property Fund Sector – Consultation Paper 145

Feedback from A&L Goodbody

Do you agree with the proposal in Consultation Paper 145 to limit leverage and introduce additional Guidance around liquidity mismatches as a means to meet the Central Bank's objective of safeguarding resilience of the property fund sector to shocks in the Irish CRE market? If not, which measures, or combination of measures, do you think best meet the objective of safeguarding resilience of the property funds sector, so that it is better able to absorb – rather than amplify – shocks in the Irish CRE market?

Response:
We appreciate the opportunity to respond to the Central Bank's Consultation Paper 145. The items covered in it are very material to both the real estate and investment fund sectors in Ireland.

We have seen and commented on the Irish Funds response to this Consultation Paper and would note our support of it. Accordingly, we do not propose to repeat answers that merely echo that response.

As regards the Central Bank's proposal to limit leverage in certain regulated Irish AIFs that invest over 50% directly or indirectly in Irish CRE, we do not support such a proposal. There are already effectively significant limitations on the use of shareholder type loans in such funds and so any further leverage limit would effectively impact on third party debt available to such funds. We do not believe it is necessary to limit the level of that debt for certain players in the market.

One consequence, which the Central Bank acknowledges, is that it is likely that any such move would lead to unregulated entities that are not subject to any leverage limits (whether through use of shareholder loans or otherwise) being used by investors or, worse still, international investors looking elsewhere as regards investment opportunities.

In addition, the CRE market is diverse and applying one limit to all sectors in the market would not be appropriate.

As regards the proposed guidance around liquidity mismatches, we note that there are already significant liquidity management requirements applicable to AIFMs managing such funds. In addition, a lot of the funds, that are not closed-ended, are heavily limited liquidity and often reserve to the board of the fund or the AIFM an ability to refuse, delay or scale-back redemption requests (and not just in a suspension of a NAV scenario). We do not believe having additional redemption requirements for such funds is necessary. However, for open-ended with limited liquidity funds where shareholders have a right to redeem upon the giving of notice (with no right for the fund to refuse or materially scale-back such request) having a minimum notice period would make sense.

Separately, we have commented below as regards the retrospective application of any of the guidance and do not believe it is appropriate for the Central Bank to apply such guidance on a retrospective basis to existing funds in light of the negative impact this may have on investors and the real estate market generally.

Do you agree that the definition of property funds – for the purposes of the proposed macroprudential measures – should include all AIFs that are domiciled in Ireland, authorised under domestic legislation, and investing over 50 per cent directly or indirectly in Irish CRE, subject to the narrow class of exclusions noted in the consultation paper? If not, what do you see as a better alternative definition of property funds for the purposes of application of the proposed measures?

Response:
We agree with the Irish Funds observations that further clarity is required as to the definition of the "property funds" which are caught by such provisions.

In addition, applying additional requirements to funds that invest indirectly in Irish real estate has the potential to be problematic (excluding where wholly owned subsidiaries are used which should constitute direct investment in any event).

We would also welcome clarification as regards the application of any new guidance to funds that invest in the provision of social housing, particularly as these are meeting a very material societal need at this time and are much less likely to be impacted by sharp market movements. This is because these funds often pursue a strategy where they acquire or develop property and then lease it on a long term basis to local authorities and so intermittent market shocks are much less likely to have a material impact on them.

Finally, development loans should be excluded. Such loans are almost always short duration (2-3 years) and the financial covenants are usually linked to cost and not LTV. Development loans are usually either paid off out of the proceeds of sale of the asset or refinanced with investment loans which could then be subject to any leverage limit that is introduced.

Do you agree with the Central Bank's proposal to have a single leverage limit, irrespective of the type of property holdings? If not, how would you differentiate the limit with respect to property holding type, and what would be the practical implications of doing so (e.g. additional, more granular data collection)?

Response:
We agree with the Irish Funds observations regarding the different types of real estate opportunities that would often attract different loan-to-value covenants from third party lenders. We note in particular the chart with varying LTV levels across different CRE market sectors in the Irish Funds response.

In addition, looking at the recent Covid-19 market impact in the CRE space this varied significantly between market sectors. Some, like PRS, fared well, others were not impacted materially while some others, such a retail, had challenges. But even in the retail space, lenders and borrowers worked through the challenges without there being a run of defaults in what was an unprecedented set of circumstances.

Do you agree with the proposed calibration of the 50 per cent total loan to total asset ratio as the appropriate leverage limit for property funds? If not, what level of leverage limit would you see as appropriate for Irish property funds, taking into account the risks the sector is exposed to and the levels of leverage employed by

property funds throughout Europe? Please explain why you have suggested this level and the evidence that would support that.

Response:
Again we note the Irish Funds response and agree with it.

In addition, in our experience even conservative third party lenders would permit loan-to-value covenants (on an ongoing basis) of greater than 50% and it would not be unusual to see 60%-65% as an ongoing covenant with a lower figure for the loan to value limit on drawdown. These reflect limits that we are seeing in the market even during and after the economic impact of Covid-19 on real estate businesses.

Accordingly if the Central Bank were still minded to impose a limit then it should be no less than 75% LTV. This would allow a buffer above third party lender covenant levels of approximately 65%. Most third party loans include cure mechanics to allow lenders and borrowers work through issues in an orderly manner and avoid fire sales of assets. Having a leverage limit below 75% will increase the risk of a regulatory breach which in turn is likely to be a material breach of the loan agreement resulting in borrowers being forced to sell assets at a time when it is very unlikely to be in the interests of investors (or the market) to do so.

Do you consider three years to be a sufficient amount of time to undertake any deleveraging in a gradual and orderly manner to meet the leverage limit as proposed, without the need to sell property assets over a short period of time? If not, what would an alternative transition timeframe be? Please explain why you have suggested this alternative length of time.

Response:
We disagree that any leverage limit should be introduced on a retrospective basis. In our experience, Irish real estate funds investing in the Irish CRE market almost always do so on the basis that the amount of capital drawn from shareholders is known at the outset, even if drawn down over time. A lot of such funds would have a term of anywhere between 7 and 15 years (perhaps longer) and

may well be fully invested at this point. Accordingly, there is likely to be no clear means of raising new equity to pay down third party debt to bring the fund under a new leverage limit. This may well lead to the funds having to sell assets or, in a worst case scenario, sell all of their assets if the assets are to be sold as a portfolio rather than individually. This may also lead to the early termination of such impacted funds at a potentially reduced IRR for investors while also possibly triggering early debt repayment obligations.

There may also be negative market impacts as a number of such funds will be forced to come to market with properties within a defined three year period.

We note also that many regulated property funds authorised since 2019 would already be subject to leverage limits agreed with the Central Bank as the Central Bank's pre-submission process has effectively lead to the imposition of leverage limits. Such leverage limits, in our experience, have been higher than 50% (often up to 75%) and accordingly all of those funds may be faced with a scenario whereby they have to reduce leverage notwithstanding that it was within limits originally agreed with the Central Bank prior to fund launch.

Do you consider the proposed approach to adjusting the leverage limit in response either to large, unanticipated adverse price shocks and/or significant overheating to be appropriate? If not, what do you see as a better alternative approach to adjusting the leverage limit to reflect cyclical risk developments in the Irish CRE market?

Response:
We note and agree with the Irish Funds response to this question. This is likely to materially add to market uncertainty particularly if the adjusted limits are then applied to existing funds. This will make the use of Irish regulated funds unattractive forcing investors into the unregulated space or away from Ireland as a market altogether.

Do you agree with the use of Guidance on liquidity timeframes (with a focus on longer notification periods) to reduce liquidity

mismatch in property funds? If not, how would you propose to reduce liquidity mismatch in property funds?

Response:
We note and agree with the Irish Funds observations in respect of the liquidity provisions applicable under AIFMD and agree that any liquidity requirements should be dealt with at an EU rather than member state level.

If the Central Bank were still minded to proceed with imposing liquidity timeframes, we would request that they do not apply to heavily limited liquidity funds where the fund has retained a right to delay, refuse or scale-back redemption requests at the discretion of the fund. This is a provision often found in the redemption provisions of such funds and would usually be coupled with a defined term for the fund in question. This ensures that there is no risk of liquidity mismatch as the fund will refuse a redemption request if it is not confident of being able to meet it, while at the same time giving investors an opportunity to at least request redemptions at a time when the fund will be able to meet them without issue.

Do you agree that 12 months is an appropriate liquidity timeframe (notification period plus settlement period) for property funds, to ensure that a sufficient timeframe is available to meet unexpected redemptions without requiring forced sales, even under conditions of collective market stress? If not, how long of a liquidity timeframe period do you think would be sufficient to reduce liquidity mismatch, even under conditions of collective market stress?

Response:
We agree with the Irish Funds observation that liquidity requirements should be dealt with at an EU level and not at a member state level per asset class.

Do you have any additional evidence on the time it takes to sell property assets in Ireland, both in normal market conditions and in times of stress?

Response:
N/A

In addition to the analysis provided in Consultation Paper 145, what potential unintended consequences do you see from the proposed measures, and how could these be mitigated?

Response:
We agree with the Irish Funds observations in respect of potential unintended consequences and have not repeated those here.

If there are any significant operational difficulties envisaged by AIFMs in complying with leverage limits imposed via Article 25, please provide brief details, including any possible solutions if appropriate.

Response:

If there are any significant operational difficulties envisaged by AIFMs in complying with the draft guidance (Annex 1 of CP 145), please provide brief details, including any possible solutions if appropriate.

Response:

Additional data in support of any of your responses to the previous questions.

Response:

If you have any further thoughts or considerations on the proposals outlined in Consultation Paper 145, please share them below.

Thank you for the opportunity to respond to this Consultation.

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