Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Macroprudential Policy for the Property Fund Sector – Consultation Paper 145

Feedback from Arthur Cox LLP

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:
In our experience in the Irish commercial real estate market, in particular in the area of Property fund formation and financing, and as expressed to us by a number of our clients, we have some concerns and questions with regard to the Central Banks proposals to limit leverage in regulated Irish property funds. We have also identified some questions with regard to the proposed guidance on liquidity.

While we appreciate the Central Bank's desire to achieve resilience in the CRE sector and to seek to ensure that shocks in that sector are not amplified, it is not clear to us that the Property Fund segment of the CRE sector, as it operates today, would amplify such shocks. Our clients consider that the property fund segment does in fact provide the very resilience that the Central Bank is seeking to achieve through its foundations in a diverse mix of international and institutional capital made up of both equity, from experienced institutional investors who are sophisticated in their understanding of the market and acceptable levels of debt within it, and debt from a diverse group of international bank and non-bank lenders who are attracted to participate in the market because of the presence of such investors as well as what they see as the fundamental strength of the market as it has developed since the global financial crisis.

In that regard, it seems that the proposals do not seem to take account of the very significant changes that have occurred in the Irish property market since the global financial crisis where the very basis for commercial property ownership has shifted significantly from one owned and financed predominantly by domestic high net worth owners and local financial institutions, to one owned and financed by the diverse global participants we note above, in large part owned and financed through regulated property fund structures.

This more developed market is similar to other global developed CRE markets and is what allows other such markets to remain resilient.

In proposing such measures then, did the Central Bank take into account that, while all real estate markets suffered to a greater or lesser degree during the global financial crisis, those more developed and diverse markets did not suffer the same impacts as were felt in Ireland where the ownership and debt profile prior to 2007 was as described above. Further, it would seem that there is an opportunity to further consider the make-up of the pre 2007 CRE market profile, and not the current diverse one, and how that impacted on any amplification in Ireland of the shocks felt in the global financial crisis as regards the CRE market.

In addition, has the Central Bank considered the impacts of seeking to impose restrictions only on the regulated property fund sector, through which the more developed global participants invest in and lend to Irish real estate structures?

A hard, low limit on leverage, in particular without any of the protections that lenders and borrowers agree in commercial, open market lending arrangements, risks discouraging participation in the Irish market by global investors and lenders in CRE.

A number of our clients have expressed a concern that the proposals seem to overly focus on open-ended structures and liquidity concerns whereas in our experience the majority of the Irish property fund market operates as closed-ended where investors expect a long horizon and market movements or even shocks within that time horizon will not always lead to forced sales and negative market events particularly where sophisticated investors and lenders have the ability to negotiate better outcomes than would otherwise occur on triggering hard limits.

Did the Central Bank consider the applicability of these proposals to close-ended structures and whether such structures inherently contain the same risks as open-ended vehicles?

We are also concerned that it would seem that the proposals do not take into account the fact that the Irish real estate market is considerably broader than the narrower property fund sector impacted by the proposals. It is therefore unavoidable that a regulatory leverage limit creates a risk of regulatory arbitrage as investors seek other legitimate means to achieve their market and investment aims. By restricting leverage in the most regulated part of the market we are concerned that the effect will be to encourage higher leverage transactions and strategies into unregulated, and therefore unreported, monitored or controlled sectors of the market. In addition, property funds impacted by the leverage limits will nevertheless be subject to market stress originating in the part of the market to which the leverage limit does not apply, thereby amplifying the negative effects of these proposals.

In addition to the above, we believe that the regulated property fund sector further provides a number of protections that make the imposition of such a limit unnecessary. These include the existing controls within regulated structures, including but not limited to the role and responsibilities of the AIFM and the board of directors and regular reporting to the CBI, all of which could in our view be relied on as the primary and most effective way to directly manage leverage in property funds. These are in addition to the normal controls imposed by lending banks through loan covenants, which are used to manage the borrowing levels relative to asset values.

Further, the proposal to apply new restrictions retrospectively to existing structures has the potential to be damaging to those structures and their investors, and may have the unintended consequence of reducing investor confidence in the jurisdiction. In this regard it would seem that the Central Bank's proposal does not contain any suggestion as to how existing funds, many of which have passed final closings, should raise additional capital, thereby forcing asset sales to achieve compliance with the new rules.

For these reasons and as set out in further detail in our complete response to the consultations questions, we believe that there is an opportunity for further thought and consideration of any such proposals.

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 have provided input into the responses of both Irish Funds and CREFC and note with approval their responses to this question.

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 have provided input into the responses of both Irish Funds and CREFC and note with approval their responses to this consultation. In addition in relation to this question, we note that a single leverage limit would not appear to take account of any differences between varying types of CRE or the stages of holding of real estate from green or brown field sites through development to fully developed and stabilised assets.

In this regard then has the Central Bank considered in their proposals how and why leverage levels might differ between development assets, where the time horizons are shorter and the LTV may be higher when only the undeveloped value of the asset is taken into account, and fully stabilised assets where longer time horizons and higher asset values may result in a lower LTV?

Further, has the Central Bank considered how the attractiveness for investors of different CRE assets over various cycles may see LTVs rise and fall over time, and as such to impose an artificially low level now may impact the ability of those segments of the CRE market to attract capital in the future?

As noted above, our clients have expressed concerns regarding the imposition of any limit such as has been suggested by this proposal and the impacts of continually revisiting that limit for structures throughout their life. In addition, the proposed measures risk subjecting borrower property funds to external market forces and events beyond their control. A leverage limit that would be tested periodically, and which could therefore be breached as a result of falling property values would in our view adversely impact market resilience. It is difficult to see how a leverage limit structured as a hard regulatory limit would not place significant pressure on the Central Bank to intervene to prevent widespread forced sales in the event of a breach.

Having said all of the above, if a limit were to be applied, we believe that certain factors should be taken into account as follows :

- In principle, the proposals should not apply to closed-ended structures where liquidity concerns are significantly lessened and investors managers and lenders have the ability to structure these products to ride out market shocks over the long time horizons for these funds;
- Certain segments of the market such as construction and development loans should be exempt from such limits taking into account the nature of such loans;
- Any limit should be applied only at inception of the loan so as to protect investors and funds from the adverse consequences of negative market movements triggering limits on an ongoing basis;
- any limit that is applied should be at such a level as to ensure that it does not have the inadvertent impact of discouraging investment in certain CRE market segments and as such should be set at a level that represents a realistic view of the actual levels of leverage in the market and allows a sufficient buffer for negative movements over the life of a fund, for example in excess of 75%, and is therefore designed to impact only outliers and not more traditional institutional investors and lenders.

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:
We have provided input into the responses of both Irish Funds and CREFC and note with approval their responses to this consultation. In addition in relation to this question, we note that our clients have queried the methodology used by the Central Bank in this consultation to assess both the leverage currently employed in the Irish property market and to asses an overall EU average.

In terms of the Irish leverage figure, it seems inappropriate to include shareholder debt which artificially increases the average leverage exposure, when such debt would not appear to behave the same way as third party debt in times of market stress. In our experience much of that debt is legacy shareholder debt, a large portion of which has likely since been redeemed, it does not include covenants of a similar nature to third party lender covenants and would not normally lead to market sales in times of stress and it is subordinated to any third party debt.

Our clients have expressed the views that if the Central Bank does proceed with its proposal, it would seem most appropriate that any limits should be set in excess of normal bank LTVs so that the financing agreement between the bank and borrower is the primary tool to regulate leverage levels and deal with situations where leverage exceeds that agreed between the bank and borrower. The Central Bank leverage level should then act only as a backstop in the situation where the normal investor/borrower and bank controls were not operating to reduce or manage leverage.

It would seem that enforcing a 50% leverage limit could result in a regulatory breach occurring before any loan to value financial covenants in the loan documentation were triggered which we believe cannot be the intended consequence. In our and our client's experience, LTVs in the range of 60-65% are common within the Irish property investment sector for stabilised core assets, which it appears constitute the majority of the market. If the Central Bank were to introduce a leverage limit it should therefore be set at no lower than 75% LTV to provide the normal covenant buffer which banks allow their borrowers.

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 have provided input into the responses of both Irish Funds and CREFC and note with approval their responses to this consultation. In addition however, we note that the proposal to retrospectively apply leverage limits to existing fund structures has raised perhaps the most significant concerns for our clients.

Fundamentally, we do not believe that leverage limits could be retrospectively applied to existing structures without creating significant artificial market volatility through forced sales and as such our clients are concerned that no period of transition is appropriate.

Furthermore, we are extremely concerned that retrospective proposals have the potential to damage Ireland's competitiveness and attractiveness as an investment market for this in-bound diverse capital due to the lack of certainty that such a proposal would give to investors in the future.

In relation then to the funds themselves, with no ability to call further capital from fully invested shareholders in closed ended funds, this will have the likely effect of forcing these funds to prematurely dispose of property assets to achieve compliance with any new limits set. Such forced sales, by their very nature, will have a negative impact on the ability of the market to naturally set prices. Additionally, a forced debt paydown ahead of contractual debt maturity would result in significant costs and penalties to investors.

On this basis, we do not believe it is possible to apply any limits retrospectively without creating a market event and the subsequent shock which would be amplified by this restriction.

We believe that existing funds and loans already in place must be grandfathered from any proposed limit.

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 have provided input into the responses of both Irish Funds and CREFC and note with approval their responses to this consultation. In addition we note that we do not consider the proposed approach to adjusting the leverage limit in response to price shocks and/or significant overheating to be appropriate.

The proposal does not seem to take into account the sophistication or experience of the lenders to regulated Irish property funds and suggests that they would not be capable of taking appropriate action in accordance with the terms of the loan agreement in response to market stresses to adjust the leverage limit if required. In addition, as noted above, if the Central Bank were to alter the limits applicable to an existing structure which was closed- ended and with no ability to call further capital, this could in itself cause a market event if where the commercial arrangements were subordinated to an arbitrary regulatory limit.

In addition, it's hard to see how the Central Bank would be able to impose such limits without having to effectively anticipate the likely movement in property values in any relevant sector

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 have provided input into the Irish Funds response to this question which response we note with approval.

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 have provided input into the Irish Funds response to this question which response we note with approval.

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:
Our clients have advise us that in principle, their experience on selling assets in Ireland is that the liquidity levels and timescale for selling is similar to other international markets in which we operate including the UK and the US. They note that timescales can increase in times of market stress and reduce in more normal market conditions but that this is in line with international experience for CRE.

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:
In addition to the unintended consequences we have noted in our responses above, we also note with approval the responses of Irish Funds and CREFC to this question and the various matters they have highlighted therein.

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.

We have provided input into the Irish Funds response to this question which response we note with approval.

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