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# Macroprudential measures for the property fund sector

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## Non-technical summary

Property funds have become a key participant in the Irish commercial real estate market in recent years. This entails benefits for both macroeconomic and financial stability, through increased diversification of funding sources. However, the changing nature of financial intermediation also raises the potential that new vulnerabilities could emerge.

In that context, the Central Bank has been examining the property fund sector in more depth, with a particular focus on two potential sources of financial vulnerability that could affect the resilience of this form of financing in future periods of stress: leverage and liquidity mismatch. The Central Bank's analysis has established that:

- A cohort of Irish property funds have elevated levels of *leverage* and – on average – Irish property funds have higher levels of leverage than equivalent property funds in Europe.
- Although Irish property funds typically have a low dealing frequency, *liquidity mismatch* is evident for a subset of property funds, given the very illiquid nature of commercial property assets.

Absent policy interventions, these vulnerabilities have the potential to grow or become more widespread in the future. And, in the presence of such vulnerabilities, the property fund sector could respond to future adverse shocks through sales of property assets over a short period of time. This type of selling behaviour has the potential to amplify adverse shocks to the commercial real estate market and the wider economy.

### ***Objective of the proposed measures***

The proposed measures aim to safeguard the resilience of this growing form of financial intermediation, so that it is better able to absorb – rather than amplify – future adverse shocks. In turn, this would better equip the sector to continue to serve its purpose as a valuable and sustainable source of funding for economic activity.

### ***Proposed measures to address leverage***

The Central Bank proposes to introduce a leverage limit for property funds. The proposed limit would be imposed through existing regulation under the Irish transposition of the Alternative Investment Fund Managers' Directive, in line with ESMA guidelines. The Central Bank recognises that there is significant diversity in portfolio composition and investment strategies across property funds, but the objective of the proposed measures is to guard against system-wide risks stemming from leverage across the sector as a whole. Given the significant variation in observed levels of leverage across the sector, the Central Bank will consider feedback on the proposed calibration of the limit carefully.

The Central Bank proposes to provide a three-year transition period to give existing property funds with leverage above the proposed limit sufficient time to adjust in a gradual and orderly manner. New property funds would be expected to meet the leverage limit at authorisation.

In the event of adverse commercial real estate market shocks, the Central Bank may temporarily remove the limit, enabling the property fund sector to absorb those adverse shocks. Similarly, the Central Bank would have the option to tighten the limit if there were to be emerging evidence of growing exuberance in the commercial real estate market.

### ***Proposed measures to address liquidity mismatch***

Existing regulation already requires fund managers to align their investment strategy, the liquidity profile of their assets and their redemption policy. In practice, however, the Central Bank has observed significant variation in the redemption terms of Irish property funds, which cannot be explained fully by differences in the liquidity of their assets.

The Central Bank therefore proposes to introduce additional Guidance for property funds on aligning their redemption terms with the liquidity of their assets. In particular, under the proposed Guidance, the Central Bank would expect to see a lengthening of the timeframe between the point at which investors would submit a redemption request and the point at which funds would need to pay those investors. This longer timeframe would better reflect the significant amount of time it takes to sell property assets, especially under stressed market conditions. New and existing property funds would be expected to follow the Guidance.

### ***Expected impact of measures***

Implementation of the measures is expected to increase the resilience of property funds, and bring Irish property funds in line with their European peers. A leverage limit would increase resilience to commercial real estate price shocks. Likewise, longer liquidity timeframes would reduce liquidity mismatch. The proposed measures to safeguard resilience need to be set against historical experience, which suggests that the Irish commercial real estate market is more volatile than many of its European counterparts.

As with all policies, these benefits have to be weighed against the potential costs. The proposed three-year transition period should limit the impact of any adjustment. Further, evidence from Germany, which has similar limits in place, suggests that these have not adversely affected the volume of new investment in property funds relative to other countries. Over the course of a full economic cycle, therefore, the measures would be expected to promote sustainable investment in Irish commercial real estate.

The consultation seeks views from all relevant stakeholders on the proposed measures. We would welcome evidence to support views provided in response to this consultation. The public consultation process will run until Friday, 18 February 2022.

# Macprudential measures for the property fund sector

The Central Bank proposes to introduce macroprudential limits on leverage and provide Guidance to limit liquidity mismatch for Irish-authorized property funds. The policy aims to strengthen the resilience of this growing form of financial intermediation, guarding against the risk that financial vulnerabilities in the sector amplify adverse shocks in future times of stress. This, in turn, would better equip the sector to continue to serve its purpose as a valuable and sustainable source of funding for economic activity.

## 1. Introduction

**Alternative Investment Funds (AIFs) domiciled in Ireland and authorised under domestic legislation with significant holdings of Irish property assets (henceforth referred to as ‘property funds’), have become a key participant in the Irish commercial real estate (CRE) market in recent years.**<sup>1</sup> Irish-authorized property funds are now estimated to hold over 40 per cent of the Irish ‘invested’ CRE market. At end-2020, their holdings of Irish property assets were valued at €23 billion, out of the €53 billion estimated total value of Irish ‘invested’ CRE.<sup>2</sup>

**Both macroeconomic and financial stability can benefit from the increased role of property funds as CRE market investors.** Property funds have increased the proportion of equity financing in the Irish CRE market relative to the period before the global financial crisis, which has had risk sharing benefits for the market. In addition, as property funds are primarily financed by foreign investors, this growing form of financial intermediation also provides diversification benefits (see Chart 1). More broadly, investment funds enable investors to access a diversified set of asset

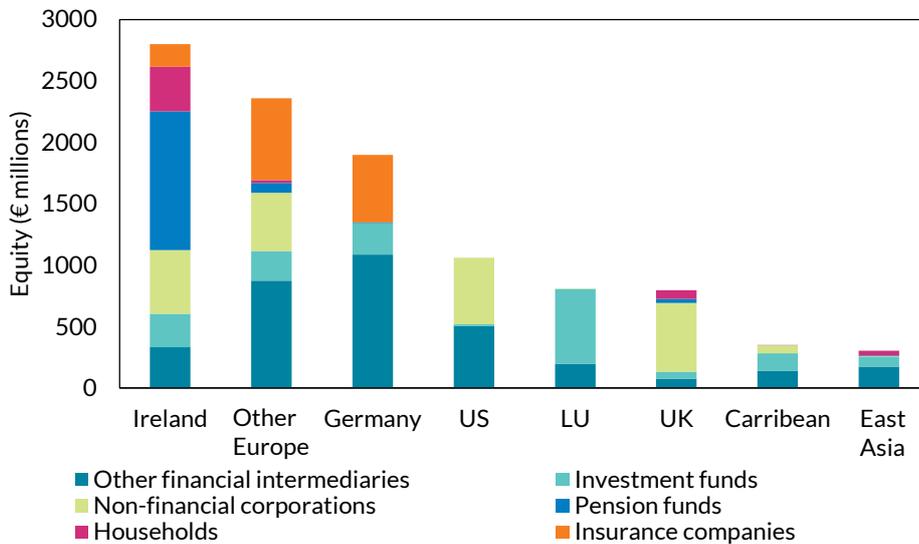
Both macroeconomic and financial stability can benefit from the increased role of property funds as commercial real estate market investors.

<sup>1</sup> Commercial real estate here is defined in line with the [ESRB definition](#), in that it refers to any income-producing immovable property, excluding: social housing, property held by end-users, and residential real estate directly owned by private households with the primary aim of being let to tenants. As such, it includes residential property owned by institutions such as funds for income-producing purposes.

<sup>2</sup> The value of the ‘invested’ Irish CRE market (i.e. the total direct holdings of physical real estate portfolios owned by professional real estate investors for investment purposes) was estimated using a combination of information from Cushman & Wakefield and Morgan Stanley Capital International.

portfolios and, in doing so, play a key role in channelling savings into long-term investments.

**Chart 1: Beneficial Investors in property funds by location and by sector**



Source: *Deep Dive Survey* and Central Bank of Ireland calculations

Notes: Information based on the top 10 investors for property funds as reported in response to the *Deep Dive Survey*.

**However, the changing nature of financial intermediation in the CRE market also raises the potential that new macro-financial vulnerabilities could emerge, so it is important that the regulatory framework adapts accordingly.** While the majority of the Irish investment fund sector invest in overseas assets, Irish property funds invest directly in the domestic Irish economy. The main risk that the Central Bank’s proposed interventions seek to guard against relates to the potential for forced selling behaviour by the property fund sector as a whole. This could lead to market dislocation, with knock-on effects for the financial sector and real economy. Leverage, and to a lesser extent liquidity mismatch, are possible sources of financial vulnerability in the property fund sector that could trigger such widespread forced sales by property funds in the event of adverse shocks. Given the size of the sector, the impact of widespread forced sales by property funds on the Irish CRE market could be significant. By extension, this behaviour could have implications for broader financial and macroeconomic stability.

**The Central Bank proposes to guard against potential future financial stability risks by introducing macroprudential limits on leverage and additional Central Bank Guidance to limit liquidity mismatch for Irish-authorized property funds.** The objective of the proposed measures is to increase the resilience of this growing form of financial intermediation, reducing the risk that financial vulnerabilities might amplify adverse shocks in future periods of stress. This in turn would better equip the sector to continue to serve its purpose as a valuable and sustainable source of funding for economic activity. In practice, the Central Bank aims to achieve

The changing nature of financial intermediation in the commercial real estate market raises the potential that new vulnerabilities could emerge.

The Central Bank proposes to guard against potential financial stability risks by introducing limits on leverage and Guidance on liquidity mismatch for Irish-authorized property funds.

this (i) by applying existing property funds regulation to place limits on their leverage, and (ii) by issuing additional Central Bank Guidance to ensure better alignment between the redemption policies of property funds and the liquidity of their assets.

**The proposed macroprudential interventions complement existing regulatory requirements.** Investment fund managers have existing responsibilities to identify, mitigate and monitor risks that may adversely affect their fund's investors, to communicate these to their investors and to use appropriate tools to manage wind-down in the event of a failure. Further, investors (in particular qualified investors) have a responsibility to understand the risks of their investments. The proposals in this consultation paper are designed to complement this framework, while addressing the wider macro-financial vulnerabilities that can arise from this sector.

## 2. Financial stability, the CRE market and property funds

### 2.1 The CRE market and financial stability

**The CRE market is systemically important.** A significant and/or unexpected disruption in the CRE market could have adverse consequences for the broader financial system and the economy as a whole. This could happen through different channels:

- **Lenders' exposures to CRE:** The most direct link between CRE markets and financial stability is through CRE loans. A dislocation in the CRE market that drives prices below fundamentals could impair the ability of CRE borrowers to service their debts and lead to losses for lenders, impairing their own capital positions and, ultimately, resulting in a reduced supply of credit to the economy. While Irish banks' exposures to CRE have reduced significantly since the global financial crisis, this remains a source of risk.
- **Financing conditions for borrowers using CRE as collateral:** Non-financial companies often use CRE as collateral to borrow from banks. In Ireland, for example, an estimated 45 per cent of Irish-resident SME exposures of Irish retail banks at end-2020 had CRE as collateral. In that context, a dislocation in the CRE market that drives collateral values below fundamentals could result in companies finding it more difficult to access finance. A dislocation such as this could have broader adverse macro-financial implications for investment, employment and growth.

The commercial real estate market is systemically important.

- **Adverse effects through the impact on, and possible spillovers from, the construction sector:** The CRE and construction sectors account for a significant proportion of economic activity. Gross capital formation of buildings (excluding dwellings) equates to over 8 per cent of GNI\* as at end 2020, and construction accounts for over 2.5 per cent of total employment. As a result, if there were to be a dislocation in the CRE market, construction could be negatively affected, with potential spillover effects into other economic sectors.

The above channels mean that a dislocation in the CRE market has the potential to have adverse macroeconomic effects. Indeed, a number of previous financial crises have been associated with sharp adjustments in the CRE market. This was the case in several countries during the global financial crisis. It was also evident during the crises in Scandinavia and Japan in the early 1990s, the US savings and loan crisis, and in the emerging markets that were most affected by the 1997–1998 Asian financial crisis (see the ESRB 2018 [Report on vulnerabilities in the EU commercial real estate sector](#)). These negative effects can be long lasting and it can take many years for the market and the economy to recover.

A dislocation in the commercial real estate market has the potential to have adverse macro-economic effects.

## 2.2 Irish property funds and the resilience of CRE financing

Reflecting the systemic importance of the CRE market, the resilience of financing of CRE activity is important. In recent years, the composition of financing of the CRE market has changed, with property funds growing in importance. Over the past 5 years, property funds’ Irish property asset portfolios are estimated to have increased by around €12 billion. As of end-2020, property funds accounted for over 40 per cent of the estimated stock of ‘investable’ real estate. This means that – all else equal – the resilience of this growing form of financial intermediation for the functioning of the Irish CRE market matters more now, than it did a decade ago.<sup>3</sup>

Central Bank analysis points to potential financial vulnerabilities in parts of the Irish property fund sector, which could affect the resilience of this form of financing in future periods of stress. When considering financial stability risks, two key potential sources of financial vulnerability have been considered by the Central Bank: leverage and liquidity mismatch.<sup>4</sup>

Potential financial vulnerabilities in parts of the Irish property fund sector could affect the resilience of this form of financing in future periods of stress.

- **Leverage:** Property funds can borrow to finance their investments through loans from banks or other lenders. In the event of adverse

<sup>3</sup> A resilient sector is one which is able to continue to provide services to the Irish economy in both good times and in bad, and which is able to absorb, rather than amplify, adverse shocks. See the [Financial Stability Review 2021:2](#).

<sup>4</sup> These are discussed in detail in a recent Financial Stability Note: [Property funds and the Irish commercial real estate market](#).

shocks, highly-leveraged property funds may breach their loan covenants (such as leverage thresholds). In response to actual or expected covenant breaches, highly-leveraged property funds may either choose or be forced to sell assets into illiquid markets over a relatively short period of time, further reducing market liquidity. Such collective selling behaviour could act as a source of amplification of stress in the CRE market in the face of adverse shocks.

- **Liquidity mismatch:** Property funds (excluding closed-ended property funds) allow investors to subscribe and redeem shares on certain days (dealing days). Adverse shocks can lead to large volumes of redemption requests. To meet these redemption requests, property funds may be forced to sell property assets over a relatively short period of time into illiquid markets. As with leverage, this could act as a source of CRE market dislocation, particularly if many investors are individually motivated to transact despite the resulting downward pressure on values. For example, investors may be incentivised by ‘first-mover advantage’ if they perceive that the first investors to transact may gain a better price while negatively affecting the positions of the remaining investors. This can arise due to fluctuations in market liquidity or transaction costs for portfolio assets, or during a shock if investors can redeem before the net asset value adjusts to fully reflect declines in portfolio values.

It is important to highlight here that it is the collective and correlated behaviour of the property fund sector, rather than any individual fund itself, that has the potential to add to market-wide pressures in periods of stress.

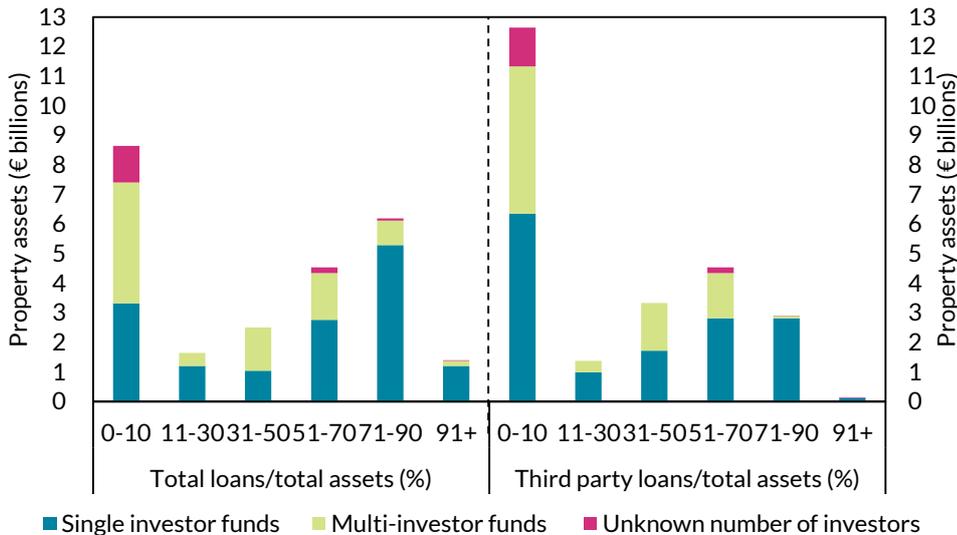
**Central Bank analysis indicates that a cohort of Irish property funds have elevated levels of leverage.** There is significant variation in leverage positions across property funds (see Chart 2). The average value of total loans to the value of total assets is around 46 per cent, but the average masks significant differences across the sector. There is a cohort of property funds with higher levels of leverage, which also means that – on average – the property fund sector in Ireland has higher levels of leverage than the whole property fund sector across Europe. For these highly-leveraged property funds, price falls could potentially result in covenant breaches, which could in turn lead to forced sales. Forced sales result in decreasing market liquidity and can cause prices to fall temporarily below fundamental values, which can in turn lead to further covenant breaches and a reduction in investors’ market expectations. This market dislocation can have knock-on effects to financial markets and the wider economy.

Two key potential sources of financial vulnerability have been considered by the Central Bank: leverage and liquidity mismatch.

A cohort of Irish property funds have elevated levels of leverage.

Part of the reason for the higher observed leverage is due to borrowing from shareholders, but – even accounting for that – there is a cohort of property funds with elevated levels of leverage.<sup>5</sup> Around 28 per cent of property funds have third party leverage above 50 per cent. In total, 88 property funds with €14 billion in property assets owe €6.7 billion in bank loans. This type of leverage is the most concerning type from a financial stability perspective, and in the absence of intervention has the potential to continue to grow, especially in a low interest rate environment.

**Chart 2: Distribution of property assets by property funds’ leverage**



Source: MMIF 2020Q4 and *Deep Dive Survey*.  
 Notes: Data includes 176 property funds with €23.4 billion in property assets. Leverage is calculated as the ratio of total loans to total assets. Single and multi-investor funds are identified based on their responses to the *Deep Dive Survey*. New funds that were not part of the *Deep Dive Survey* are classified as having an unknown number of investors.

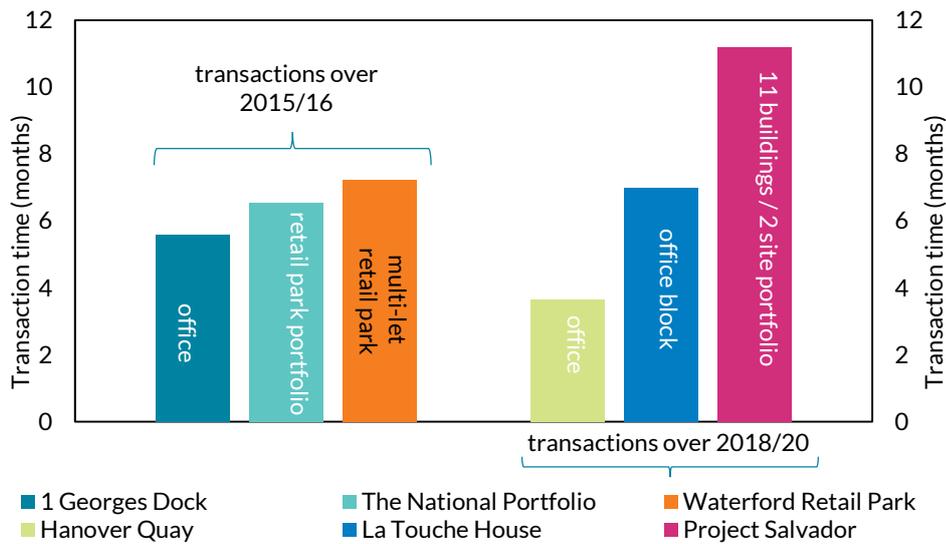
Although Irish property funds have a low redemption frequency, Central Bank analysis indicates that liquidity mismatch is also evident for a significant subset of property funds. Liquidity mismatch is primarily assessed by comparing a fund’s ‘liquidity timeframe’ to the expected time to sell its property assets. The Central Bank considers the overall ‘liquidity timeframe’ of an investment fund to be the sum of the standard notification period (the number of days before the dealing day that investors are required to notify the fund of their intention to redeem) and the settlement period (the maximum time available to a fund to settle redemption requests). Therefore, the liquidity timeframe represents the maximum length of time between the point at which an investor can request a redemption and the point at which the fund must pay out that redemption. On the other hand, the expected time to sell a property to meet redemption requests will depend on the liquidity of the underlying market, which will likely vary depending on the prevailing macro-financial environment. While

Liquidity mismatch is also evident for a significant subset of property funds.

<sup>5</sup> See ID1141 and ID1142 of the [Central Bank’s AIFMD Q&A](#), which set out further details on the circumstances under which raising capital from shareholders is permissible.

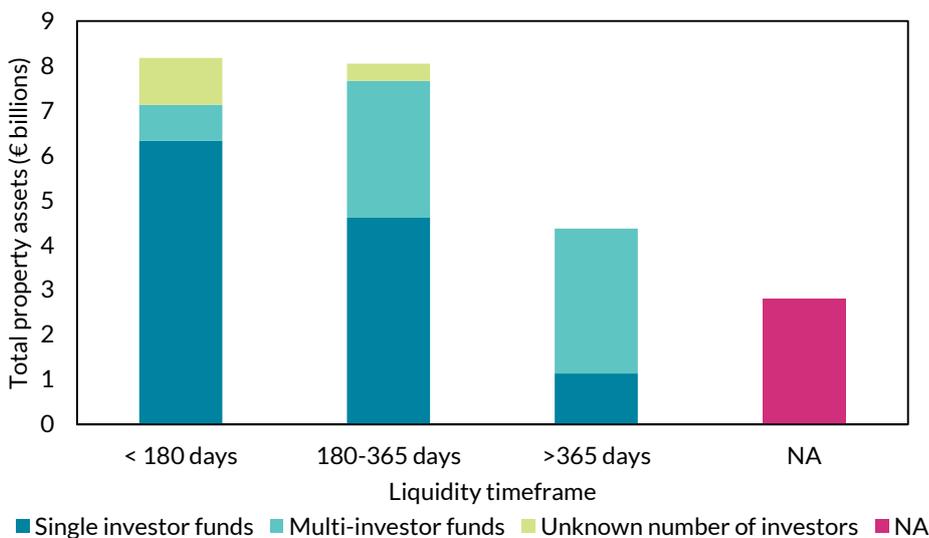
there is little evidence on the actual time to sell commercial property across the entire Irish CRE market, based on evidence from previous selected transactions it takes on average 6-7 months (i.e. 180 to 213 days) to dispose of a commercial property asset under normal market conditions (see Chart 3). Under stressed conditions, this would be expected to increase. And, of course, this average can mask significant variation depending on the specific assets. By comparison, 35 per cent of property funds' total property assets are held by funds that have a liquidity timeframe of less than 180 days (see Chart 4).

**Chart 3: Select Irish CRE transaction times**



Source: JLL

**Chart 4: Distribution of property funds' property assets by reported liquidity timeframe**



Source: MMIF 2020Q4 and prospectus information.

Notes: Information on notification and settlement periods is taken from fund prospectuses. 'NA' relates to 36 funds (with €2.8 billion in property assets) for which information on notification and settlement periods is unavailable.

**Survey results based on fund managers’ own assessments of time to sell property also indicate liquidity mismatch in property funds.** Based on data from the Central Bank’s *Deep Dive Survey* and funds’ prospectuses, €6 billion in property assets could not be sold within property funds’ own estimates of the time it would take to sell them under normal conditions (see Table 1). In value terms, this represents 1.5 times the total average annual investment transactions of CRE from 2014-2019. Should widespread redemptions and consequent forced sales occur, the new flows onto the market could substantially exceed the volume it normally supports, leading to market dislocation.

Survey results also indicate significant liquidity mismatch.

**Table 1: Comparison of property funds’ property liquidity and liquidity timeframes (€ billions)**

		Liquidity timeframe (days)			
		<180	180-365	>365	N/A
Property liquidity buckets (days)	<180	2.7	0.6	2.9	-
	180-365	2.3	5.3	1.5	-
	>365	2.1	1.6	-	-
	N/A	1.0	0.5	0.0	2.8
<b>Total (€ billions)</b>		8.2	8.0	4.4	2.8

Source: MMIF 2020Q4, *Deep Dive Survey* and prospectus information.

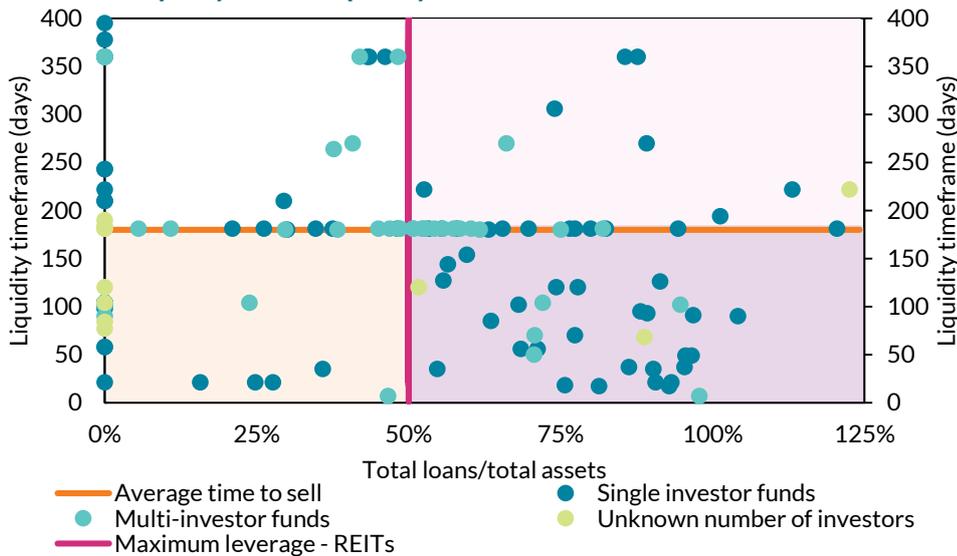
Notes: Data includes 176 property funds with €23.4 billion in property assets. Information on liquidity timeframes is unavailable for 36 property funds with €2.8 billion in property assets. Information on property liquidity is based taken from the *Deep Dive Survey* and is based on property funds’ expectations of how long it would take to liquidate property assets under ‘normal conditions’ as at 2019Q4. Information on property liquidity is not available for 16 property funds with €1.6 billion in property assets.

**A cohort of property funds have both liquidity mismatch and higher leverage.** Chart 5 shows that there is a cohort of property funds that have leverage above 50 per cent and a liquidity timeframe of less than or equal to 180 days (dark shaded area). In total, 35 property funds, representing €5.2 billion of property assets (or around 1.3 times the 2014-2019 average annual CRE investment transaction volume) both have liquidity timeframes of less than 180 days and have leverage greater than 50 per cent. These funds are particularly vulnerable to an external shock or sudden economic downturn. For example, highly-leveraged property funds that also exhibit liquidity mismatch may be more susceptible to increased redemption risks by investors in periods of stress.

A cohort of property funds have both leverage and liquidity issues.

**Overall, there is a cohort of property funds where financial vulnerabilities are present.** In the face of adverse shocks, this cohort of funds may need to sell property assets quickly, with adverse implications for the functioning of the broader CRE market. This would act as an amplification mechanism for shocks. More broadly, if left unchecked, there is a potential for some of the vulnerabilities to grow over time, not least given the rapid growth in the sector observed in recent years.

**Chart 5: Property funds' liquidity timeframe vs loans to total assets ratio**



Source: MMIF Q4 2020 and prospectus information.  
 Notes: Data includes 140 property funds with €20.6 billion in property assets. Information on liquidity timeframes is unavailable for 36 property funds with €2.8 billion in property assets.. Information on notification and settlement periods is taken from fund prospectuses. For clarity, chart excludes 7 property funds (3 single-investor and 4 multi-investor) with liquidity timeframes over 400 days.

### 3. Objectives of the macroprudential measures

The proposed macroprudential measures aim to increase the resilience of Irish property funds, so that this form of financial intermediation is better able to absorb – rather than amplify – adverse shocks to the CRE market as a whole. The Central Bank proposes to limit leverage and provide Guidance on liquidity mismatch in property funds, with a view to increasing the resilience of this key and growing form of CRE financing. In doing so, the potential for leverage or liquidity mismatch to contribute to a disruption in the CRE market when shocks hit, would be reduced. This would, in turn, limit the knock-on effects onto the financial sector and real economy, and better equip the sector to serve its purpose as a valuable and sustainable source of funding for economic activity.

**Policy objective**

The proposed macroprudential policy aims to increase the resilience of Irish property funds, so that this form of financial intermediation is better able to absorb – rather than amplify – adverse shocks. This would better equip the sector to serve its purpose as a valuable and sustainable source of funding for economic activity.

Reflecting this objective, the proposed measures would apply to Irish domiciled funds investing in Irish property. Specifically, the policies would apply to AIFs domiciled in Ireland, authorised under domestic legislation, and investing over 50 per cent directly or indirectly in Irish property assets (referred to in this paper as property funds).<sup>6</sup>

This proposed intervention is consistent with the Central Bank's broader priority to develop and operationalise the macroprudential framework for investment funds, working with international counterparts. The Central Bank has previously highlighted the need to develop and operationalise the macroprudential framework for the market based finance sector, both within Ireland and across Europe (see Governor Makhoulf, 2020 [Making the case for macroprudential tools for the market-based finance sector: lessons from COVID-19](#)). As the financial system evolves, it is critical that the macroprudential framework remains fit for purpose to safeguard financial stability. These proposals focus on the segment of the investment fund sector that has the closest links with the Irish domestic economy.

The policies are not intended to replace or substitute for funds' or investors' own risk management procedures. The measures are designed to mitigate financial stability risk: that is, risks arising from collective action problems that can affect the real economy. They are not designed to eliminate risk from investment activities undertaken by property funds on behalf of investors (i.e. the risk of capital loss), and should not be seen as target or optimum levels of leverage or liquidity for any given fund. Funds should select levels of leverage and liquidity timeframes within the limits (and subject to any other regulatory requirements) that best meet the needs of their investors and align with their stated investment policies. Investors should continue to do their own due diligence to ensure that the funds in which they invest have a risk-return profile that meets their needs.

The proposed measures would apply to Irish funds investing in Irish property.

This intervention is consistent with the Central Bank's priority to develop and operationalise the macroprudential framework for investment funds.

## 4. Choice of macroprudential measures

A key principle of the Central Bank's approach to macroprudential policy is to strengthen resilience *before* adverse shocks occur. This principle also

<sup>6</sup> Note: the calculation of indirect exposure excludes non-redeemable, publically traded shares in entities that are independent third parties to the fund. Investment in these is considered at this stage to pose insignificant risk of triggering fire sales of the underlying property assets, and their inclusion has the potential to trigger an unanticipated breach for funds who are engaged in passive market equity trading. This class is very narrow, but includes, for example, shares in publically listed property companies where the company is majority owned and controlled by parties that are independent third parties to both the fund and the fund manager. The exclusion may be removed in future if it is considered to result in regulatory arbitrage.

underpins the Central Bank's proposed approach to limit potential risks stemming from the property fund sector. Property funds have a wide range of liquidity management tools available, including temporary suspensions of redemptions (available to all property funds), redemption gates, redemptions in kind, anti-dilutions levies and temporary borrowings (widely, although not universally, available). Similarly, Central Bank engagement with fund managers indicates that in instances of a bank covenant breach, a fund may be able to obtain covenant waivers or renegotiate the terms of the loan with the loan provider or be able to raise more equity. However, these measures are fundamentally *ex-post* (after the event) and do not help build *ex-ante* (before the event) resilience to shocks. The effectiveness of *ex-post* measures may not be reliable in all situations. Therefore the Central Bank aims to use *ex-ante* policies to increase the resilience of the financial system *before* a shock occurs.

A key principle of macroprudential policy is to strengthen resilience *before* adverse shocks occur.

## 4.1 Measures to address leverage

**Total loan to total asset value limits are the simplest, most direct approach to guard against the risk of excessive leverage in property funds.** Property funds borrow from a number of sources, including banks, other financial institutions and their own shareholders. Limits on total loans to total asset values act to restrict this type of on-balance sheet leverage.<sup>7</sup> Rather than focusing on one type of loan or lender, the Central Bank has determined that a leverage limit of this type (or the equivalent gross leverage or commitment leverage limit) is the most aligned with the macroprudential purpose of the tool.

Total loan to total asset limits are the simplest, most direct approach to guard against the risk of excessive leverage in property funds.

**Including all types of loans minimises the possibility for regulatory arbitrage.** Including loans from affiliated parties and shareholders reduces the options for increasing leverage via unregulated affiliated entities. Further, the inclusion of shareholder loans is consistent with the Central Bank's expectations regarding these types of loans, as outlined in the [Central Bank's Alternative Investment Fund Managers' Directive \(AIFMD\) Q&A](#) (ID 1141 and 1142). The Q&A outlines that such arrangements are not, in principle, consistent with the objective of collective investment. While there are circumstances in which such arrangements could take place, these transactions must meet a number of criteria that the Central Bank has set out, which make them more akin to commercial lending arrangements.

**The Central Bank already has the power to impose leverage limits on funds in line with macroprudential needs.** Regulation 26 of the [European](#)

<sup>7</sup> The total loan to total assets ratio is a measure of on-balance sheet leverage. In general, unlike some other fund types, property funds do not utilise substantial volumes of synthetic (off balance sheet) leverage.

[Union \(Alternative Investment Fund Managers\) Regulations 2013](#) (the Irish transposition of Article 25 of the AIFMD – the Irish AIFM Regulations) provides that the Central Bank may impose limits to the level of leverage that an Alternative Investment Fund Manager (AIFM) is entitled to employ, to limit the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system or risks of disorderly markets. Thus, use of this regulation represents the most transparent and straightforward approach to regulating leverage in property funds.

**An alternative approach would be to seek to limit investment fund leverage through limits imposed on lenders.** However, any approach to regulating lending by financial institutions would be indirect. Therefore, it would likely be less effective overall than a direct approach. For example, property funds borrow from a range of sources, including non-Irish banks, other financial institutions (such as insurance companies) as well as, in certain circumstances, their shareholders. Direct limits on property fund leverage are therefore likely to be more effective.

## 4.2 Measures to address liquidity mismatch

**In the case of liquidity mismatch, the most effective ex-ante mechanism currently available to regulatory authorities is contained in the regulatory framework for AIFs.** Regulation 18 of the Irish AIFM Regulations 2013 outlines AIFMs obligations with respect to liquidity management in AIFs. When applied appropriately by an AIFM, this should result in the investment strategy, the liquidity profile and the redemption policy of the AIF being consistent. In practice, however, the Central Bank has observed significant variation in whether property funds align redemption policies with the liquidity profile of the assets, particularly in periods of market stress. As a result, the Central Bank proposes to issue additional Guidance with respect to how Regulation 18 should be applied. While this Guidance is specific to Irish property funds, it may also have more general value to other types of AIFs when interpreting Regulation 18.

In principle, there are a number of approaches that funds could use to address liquidity mismatch.

**In principle, there are a number of approaches that funds could use to address liquidity mismatch.** Not all of these are likely to be equally effective in the case of property funds. Specifically:

1. **Increasing liquid asset buffers:** While this can be a useful tool for addressing liquidity mismatch, in the case of property funds it is likely to be less effective. Property funds hold mainly real property assets, which are large and very illiquid. Therefore it is likely to be difficult for property funds to replenish their liquid asset buffers should they experience large volumes of withdrawals. In addition, property funds

cannot vertically slice their portfolios to meet redemptions.<sup>8</sup> This means that *ex-ante* higher liquid asset holdings are unlikely to be sufficient to address liquidity mismatch for property funds.

2. **Liquidity management tools (LMTs):** These tools should be used to manage liquidity mismatch where needed, under normal market conditions and in times of stress. However, LMTs in of themselves are not substitutes for the alignment of redemption terms with the liquidity of the assets. Notwithstanding the importance of LMTs for funds, these tools are *ex-post* in nature and as such do not address liquidity mismatch *ex-ante*. In addition, tools that aim to better pass on the liquidity costs to redeeming investors are likely to be less effective in the case of property funds, given: (i) the very illiquid nature of property assets; (ii) the long timeframes for disposing of property; and (iii) the uncertainty associated with estimating those liquidity costs for property investments, especially in times of stress. As such, LMTs should be used to complement *ex-ante* tools, and should not be relied upon exclusively in order to manage redemption requests.
3. **Increasing the timeframe of redemptions terms:** A longer timeframe between the point at which an investor submits a redemption request (the notification cut-off point) and the point at which investors would expect to receive the redemption proceeds (settlement point) increases the time available to property fund managers to dispose of properties in an orderly manner. This could be achieved, for example, through longer notification periods (increasing the number of days prior to the dealing day by which investors must request a redemption), ensuring alignment with the liquidity of property assets in both normal and exceptional circumstances. This would also reduce the risk that disposals are carried out in a way that disadvantages investors who remain in the property fund or new investors (e.g. if the manager were to choose to sell the property fund's highest quality, most liquid assets to meet redemptions).

The Central Bank proposes to introduce additional Guidance on redemption terms.

**Given the limitations of the first two options outlined above, the Central Bank's judgement is that aligning the timeframe of redemption terms with the liquidity of assets is the most effective way of reducing liquidity mismatch for property funds.** The Central Bank proposes to introduce additional Guidance in relation to how Regulation 18 of the Irish AIFM Regulations should be interpreted. In particular, the proposed Guidance sets out further details on how redemption terms (e.g. notification periods and settlement periods) should be appropriately used by a property fund to

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<sup>8</sup> Vertical slicing refers to selling assets with different liquidities proportionally in order to meet redemptions.

ensure alignment with the liquidity profile of the assets in that fund under both normal and stressed market conditions.

## **Box: Leverage and liquidity regulation for property funds internationally**

**There is currently no substantial legal or policy framework for the macroprudential regulation of investment funds in Europe.** Article 25 of the AIFMD provides for the imposition of leverage limits that AIFMs are entitled to employ with respect to the AIFs they manage, where the use of leverage by those AIFs contributes to systemic risk or disorderly markets. However, limits have yet to be imposed on funds by any country in Europe under this Article. In December 2020, ESMA released [guidelines](#) as to how National Competent Authorities should interpret Article 25.

**However, as noted in the 2021 ESRB NBFMI Monitor, most jurisdictions in Europe have regulation in place to deal with leverage and liquidity mismatch in property funds.** Many countries have leverage limits in place, although they often vary depending on the types of investor. To manage liquidity mismatch, many jurisdictions (Germany, France, Luxembourg, Hungary, Portugal and Slovakia) use liquidity buffers or minimum notification periods. Others (Belgium, Italy, the Netherlands and Poland) have only closed-ended property funds ([ESRB Non-bank Financial Intermediation Monitor 2021](#)).

**Germany - the largest domicile for real estate investment funds in Europe - has in place 50 per cent leverage limits for spezialfonds (targeted at institutional investors).** For retail investors, the limit was reduced to 30 per cent under domestic regulation in 2011, and a 12-month notification period was introduced. Nevertheless, the German property fund sector has experienced robust growth over the past decade.

**In the UK, the FCA has created a new category of funds: long term asset funds (LTAFs), in response to redemption requests and dealing suspensions by some open-ended UK property funds in 2016.** While the affected group of funds are quite different from Irish property funds - they are primarily open-ended with more frequent dealing, but also tend to invest in the UK's deeper CRE market - they were also identified as having similar potential vulnerabilities. The FCA has now announced minimum notification periods for LTAFs, and has introduced a 30 per cent limit on the value of their borrowings relative to the value of their property assets (see PS21/14: [A new authorised fund regime for investing in long term assets](#)).

## 5. Leverage limit

### 5.1 Details of the proposed leverage limit

To guard against excessive levels of leverage across the property fund sector, the Central Bank proposes to introduce a limit on the ratio of property funds' total loans to their total assets (hereafter the "leverage limit"). This limit would apply to all property funds as defined earlier, and would apply on an ongoing basis. In practice, this would affect Qualified Investor AIFs that meet the property exposure criteria and currently have leverage in excess of this level. Retail Investor AIFs would not be impacted as they are currently covered by the existing leverage limit of 30 per cent as set out in the [Central Bank's AIF Rulebook](#).

The Central Bank proposes to introduce a leverage limit for property funds.

The Central Bank recognises that there is substantial heterogeneity in property funds' CRE portfolios, as well as differences in their underlying investment strategies, however – given the objectives of the measures – proposes to apply a single limit across the sector. Property funds' exposures to Irish CRE include retail, office, industrial, and residential properties. These are affected by different sector-specific trends and the risk of price falls may be different across these. Furthermore, there is significant variation in the underlying investment strategies across different funds, with a diverse nature of investors. Nonetheless, the Central Bank proposes to apply a single limit across the sector. This reflects three factors. First, in periods of stress, correlations between asset prices tend to increase, so in a severe shock it is likely that multiple segments of the CRE market would be adversely affected. Second, seeking to apply different leverage limits depending on exposure type or precise investment strategy would increase complexity in the regulatory approach, which also entails costs. Finally, while different investors may have varying investment strategies, such differences may not warrant variation in the application of these measures, as their objective is macroprudential. That is, the proposed measures are intended to guard against the system-wide risks associated with the build-up of leverage across the entire sector, which could have adverse macro-financial implications in times of stress.

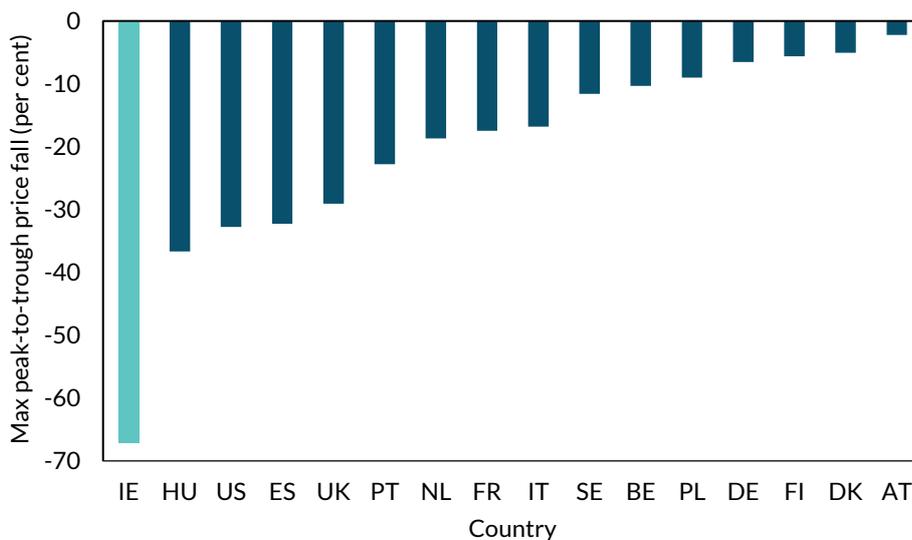
The Central Bank is consulting on a 50 per cent leverage limit, but recognises that the precise calibration involves trade-offs. For example, given the significant variation in observed levels of leverage across the sector, a tighter (looser) calibration would increase (reduce) the degree of adjustment that would be required by some existing funds, but also strengthen (limit) its resilience benefits. The proposed calibration reflects domestic and international practice, and recognises the historical volatility of the Irish CRE market. Factors that the Central Bank has taken into

account in considering the proposed calibration of the leverage limit for property funds include:

- The average, actual European leverage for property funds, which in 2020 was around 25 per cent. Although to some extent this reflects differences in structures and markets, the proposed 50 per cent calibration lies significantly above those average levels and would effectively seek to limit outliers with higher levels of leverage.
- More broadly, historical experience shows that Irish CRE markets are more volatile than many of their European counterparts (see Chart 6). Year-on-year CRE price falls in Ireland have exceeded 40 per cent, and peak-to-trough price falls in the last crisis were almost 70 per cent. Future price falls of this nature could compromise funds' ability to remain within their covenant limits or refinance their debt, and may lead to forced sales of property assets.
- Leverage limits for property funds are in place in other countries (see Box). For example, Germany, one of the largest locations for property funds in Europe, has a 50 per cent leverage limit in place for *spezialfonds*, which is the fund group targeted at institutional investors.
- Leverage of Real Estate Investment Trusts (REITs) in Ireland – another key participant in the CRE market – is also restricted, with the level of borrowings within the company not allowed to exceed 50 per cent of the market value of the properties held (see the [Finance Act 2013](#)).

Historical experience shows that Irish commercial real estate markets are more volatile than many of their European counterparts.

**Chart 6: Maximum peak to trough falls in CRE prices – 2006-2020**



Source: MSCI data, Central Bank of Ireland calculations.

Notes: Calculated based on largest peak-to-trough fall for property cycles in each country between 2006 and 2020. Peak is defined as year after which prices fall for a minimum of two consecutive years. Trough is defined as year after which prices increase for a minimum of two consecutive years.

**The proposed limit would be imposed through Article 25 of the AIFMD, as transposed to Irish law by way of Regulation 26 of the Irish AIFM Regulations, in line with ESMA guidelines.** Article 25 of the AIFMD, as transposed by way of Regulation 26 of the Irish AIFM Regulations, allows for the application of fund-specific leverage limits on financial stability grounds. As part of the regular annual assessment of funds, the use of leverage by property funds would be determined based on their regularly reported asset and liability values. Consistent with ESMA guidelines, those property funds with levels of leverage close to, or above the limit would be issued with a leverage limit pursuant to Article 25 of the AIFMD (Regulation 26 of the Irish AIFM Regulations). In practice, it is expected that this would most commonly be applied as an ‘adjusted gross leverage’ limit.<sup>9,10</sup> After each assessment, ESMA would be notified of the results, and funds would be issued with a notice confirming the application of the limit. While property funds with low levels of leverage would not be subject to a binding limit in a given year, should their total loans to total asset values increase to levels exceeding the limit they would be subject to a binding limit the following year. The leverage limit would therefore de facto apply to all property funds registered in Ireland.

The limit would be imposed through Article 25 of the Alternative Investment Fund Managers Directive, in line with ESMA guidelines.

## 5.2 Compliance and transition period

**The Central Bank recognises that property funds with current leverage levels above the proposed limit would require time to adjust.** The Central Bank therefore proposes to provide a three-year transition period for those funds. Over that time, existing property funds that are currently in excess of the limit would be required to gradually reduce their leverage to meet the new limit. The transition time is materially longer than is generally given to funds to comply with new regulatory requirements. This extended timeframe is intended to provide property funds with sufficient time to reduce their leverage in an orderly manner.

The Central Bank proposes to provide a three-year transition period to give funds time to adjust.

**Property funds exceeding the leverage limits would determine their own plan to gradually reduce their leverage.** Property funds with loans in excess of 50 per cent of their total asset values at a specific date would be subject to an assessment under Regulation 26 of the Irish AIFM

<sup>9</sup> Adjusted gross leverage is equal to the sum of long and short values of individual exposures in which the AIF is trading and main categories in which the AIF is invested, in base currency, and excluding those relating to foreign exchange held for investment purposes, foreign exchange held for hedging purposes, and interest rate derivatives, divided by the fund’s net asset value.

<sup>10</sup> There are four separate definitions of leverage provided for by the [ESMA guidelines](#), and the limit may be issued as any combination of these. For example, a 50 per cent limit on the ratio of total loans to total assets may be set as 200 per cent gross, adjusted gross, or commitment leverage, or 100 per cent financial leverage limit. The choice of metric would depend in part on the determined relative accuracy of funds’ AIFMD reporting under each metric.

Regulations. These funds would then be required to put in place a plan to reduce their leverage in a gradual and orderly manner within the three-year timeframe. Consistent with Regulation 26 the Irish AIFM Regulations, the Central Bank may impose individual interim limits (on a path towards 50 per cent total loans to total asset values) on some property funds in one or more years of the transition period. This would be done to ensure that all property funds are deleveraging gradually and appropriately.

**New property funds would be expected to structure their operations and related fund documentation to limit their total loans to below the leverage limit.** These funds would be subject to the annual assessment in each year after their first reporting date.

New property funds would be expected to limit their leverage.

### 5.3 Monitoring and review

**Consistent with other regulatory requirements, the leverage limit would be subject to regular monitoring and review by the Central Bank.** Regular monitoring would aim to ensure that the leverage limits are achieving their macroprudential aims, and that they are not imposing undue burden on market participants or the broader economy.

**Property funds that are close to or in excess of the leverage limit would be notified annually in line with ESMA's AIFMD Article 25 assessment process.** The Central Bank intends to review the leverage limit at that time, and report as part of the Central Bank publication, *the [Financial Stability Review](#)*.

In the event of commercial real estate market shocks, the Central Bank may temporarily remove the limit.

**In the event of adverse CRE market shocks, the Central Bank would consider temporarily removing the limit, subject to conditions.** The Central Bank acknowledges that large, unanticipated price corrections may mean that some property funds would inadvertently breach the limit, even if they maintained a prudent buffer. In such instances, the affected funds may also not be in a position to take immediate steps to comply with the leverage limit without further compromising financial stability. The objective of the proposed measures is to ensure that property funds are better able to absorb – rather than amplify – shocks in times of stress. To achieve that aim, those buffers need to be useable. Therefore, in the case of a substantial decline in values, the Central Bank would consider removing the limit temporarily for property funds. This may be subject to conditions, for example, that those funds do not raise additional debt.

**The Central Bank would also retain the option to tighten the limit, as may be required, depending on macro-financial developments.** Consistent with the macroprudential purpose of the regulation, the Central Bank would consider tightening the limit in the event that signs of significant overheating in the Irish CRE market are identified. In those circumstances

The Central Bank would have the option to tighten the limit.

the risk of larger price falls would increase, so property funds may need to countercyclically reduce their leverage in order to be resilient to those shocks. Given the proposed calibration of the limit, the Central Bank would not be expecting to take this action unless there was significant emerging evidence of price misalignments. In addition, any tightening would be accompanied by an appropriate notice period and transition time to allow funds to meet the new limit.

## 6. Aligning redemption terms to asset liquidity

### 6.1 Guidance on redemption terms

**The Central Bank has observed that there is significant variation in the redemption terms of property funds, which is not consistently related to the liquidity of their underlying assets.** Existing requirements, in particular Regulation 18 of the Irish AIFM Regulations, requires that an AIFM, for each AIF it manages, ensure consistency between their investment strategy, the liquidity profile and the redemption policy. This alignment should be maintained both during normal periods and during periods of market stress. When applied appropriately by an AIFM, this should result in any potential liquidity mismatch being effectively managed. However, the Central Bank has observed that there are significant differences in how individual property funds structure their redemption policies.

**Specifically, there is significant variation in the timeframe between the point at which an investor's redemption request has to be submitted (the notification cut-off point) and the point at which investors would expect to receive cash from the fund (the settlement point).** In practice, across the universe of property funds, this timeframe varies from 7 days to more than 3 years. While the Central Bank recognises that there is significant variance in the underlying liquidity of Irish property funds' assets, this does not appear to justify the observed variation in their redemption terms.

**Many European jurisdictions use minimum notification periods and other tools to reduce liquidity mismatch.** According to the [ESRB Non-Bank Financial Intermediation Monitor 2021](#), there is a wide range of measures used across other European jurisdictions to manage liquidity mismatch. Ten countries indicate that they either have ex-ante liquidity measures (such as minimum notification periods) in place for at least some types of real estate funds, or only have closed-ended real estate funds (see Box).

There is significant variation in the redemption terms of Irish property funds.

The Central Bank proposes to provide Guidance, to better align redemption terms with the liquidity of assets.

**The Central Bank proposes to provide additional Guidance with respect to how Regulation 18 should be applied in the case of property funds, with a view to better aligning redemption terms with the liquidity of assets for property funds.** The Central Bank judges that property funds' redemption policies should allow a significant timeframe between the dealing cut-off point and the settlement point. This period should be sufficient to ensure alignment between asset liquidity and redemption policies both during normal times, and during periods of market stress, when asset disposal may be difficult. At this stage, the Central Bank is proposing that this outcome be achieved through additional Guidance related to existing rules, rather than through new regulation. The draft Guidance is outlined in Annex 1.

**The Central Bank recognises that there is significant variance in the underlying liquidity of Irish property funds' assets.** For example, according to the statistical returns for 2020 and the *Deep Dive Survey*, only 19 per cent of retail CRE could be sold within 6 months, while 51 per cent of office CRE could be sold within this timeframe under non-stressed conditions (see Table 2). The liquidity of the assets is also likely to deteriorate in periods of stress. The average time-to-sell that property funds use in their internal stress tests is 14 months. The Central Bank judges that – in considering their redemption policy – property funds should focus not only on liquidity under normal market conditions, but also on liquidity under stressed conditions. As part of this consultation, the Central Bank would welcome any additional evidence on the time to sell CRE assets across the Irish CRE market both under stressed and normal conditions.

In considering their redemption policy, property funds should focus on liquidity in stressed conditions.

**Table 2: Reported liquidity of property funds' property assets (in normal times), by liquidity bucket, € billions and property type**

Property type	Property liquidity buckets (€ billions)			
	<180 days	180-365 days	>365 days	NA
Office	4.1	3.4	0.5	-
Retail	1.0	2.2	1.9	-
Residential	0.5	2.4	0.7	-
Industrial	0.6	0.2	0.2	-
Land/development	0.1	0.8	0.5	-
Other	0.1	2.2	0.3	-
Unknown	-	-	-	1.6
<b>Total property</b>	<b>6.4</b>	<b>11.2</b>	<b>4.2</b>	<b>1.6</b>

Source: MMIF 2020Q4 and *Deep Dive Survey*.

Notes: 'Unknown' CRE assets relates to property funds for which information on a property fund's property type or its liquidity is not available.

**Based on the Central Bank's analysis, the liquidity timeframes for Irish property funds would typically be expected to be a minimum of 12 months.** The Central Bank recognises that property funds' liquidity timeframes may vary depending on their specific characteristics. This reflects the following factors:

- Even in normal times, and according to property fund managers' own assessments, the average time to sell an Irish property asset is around 6-7 months. Further, there is substantial variance around those averages, depending on the individual asset.
- This timeframe is likely to be longer in periods of market stress. For example, the average time-to-sell that property funds use in their internal stress tests is 14 months. This is consistent with broader evidence around market liquidity and increased uncertainty, as well as property fund managers' own views in response to the Central Bank's survey.
- More broadly, while individual property funds may judge that they could dispose of a property over a given timeframe without affecting

The liquidity timeframe would typically be expected to be a minimum of 12 months.

market prices, that timeframe is likely to be longer if all property funds were behaving in a similar manner.

- Finally, although some properties may be able to be sold more quickly, a longer timeframe reduces the risk that the manager may choose to sell the fund's highest quality, most liquid assets to meet redemptions.

**The Guidance would outline the Central Bank's judgement that longer notice periods are better able to guard against 'first mover advantage' dynamics than longer settlement periods.** Property funds should appropriately balance their notification and settlement periods. There should be sufficient time after the notification of an investor's intention to withdraw funds for both the liquidation of property assets held by the fund and the settlement of redemption proceeds with the underlying investor. The use of longer notification periods would help to prevent the development of misaligned incentives that can trigger first-mover advantage dynamics, which could in turn otherwise lead to possible CRE market dislocation. It would also act as a protection for non-redeeming investors.

The Guidance would also draw attention to the considerations that should form part of the design phase of the fund, including ensuring an appropriate liquidity structure is selected (i.e. open-ended with limited liquidity or closed-ended).

## 6.2 Compliance

**New and existing property funds would be expected to follow the Guidance.** New property funds would be expected to take the Guidance into account at the authorisation stage, whereas existing property funds would be expected to make any necessary changes to their structure and fund documentation at the earliest possible opportunity.

## 6.3 Monitoring and review

**The Guidance would be subject to on-going monitoring, and review.** To ensure that property funds are following the Guidance, the Central Bank may carry out on-going monitoring and/or a thematic review. Monitoring would ascertain whether the Guidance is achieving its aims, and that it is not imposing undue burden on the industry and the broader economy.

**Further regulation may be introduced at a later stage.** The Central Bank would potentially consider using Central Bank Regulation to implement minimum notification periods in the event that the Guidance did not achieve the outcomes that the Central Bank judges to be appropriate to safeguard financial stability.

Funds should appropriately balance their notification and settlement periods.

New and existing property funds would be expected to follow the Guidance.

## 7. Impact analysis of the measures

**Implementation of the measures (i.e. leverage limits and aligning redemption terms to asset liquidity) is expected to increase the resilience of the property fund sector.** It is anticipated that the proposed macroprudential measures would act to substantially mitigate the financial stability risks outlined in section 2.

**A leverage limit would increase resilience to CRE price falls.** A historical value at risk model for CRE indicates that there is a 99 per cent probability that the annual loss on Irish CRE is less than 42.6 per cent, and a 95 per cent probability that the loss over two years is below 46.4 per cent. By reducing their leverage to below 50 per cent, property funds would be better able to withstand tail price falls.

**Longer liquidity timeframes would reduce liquidity mismatch.** For example, a 12-month notification period across the sector would substantially reduce the degree of liquidity mismatch, and considerably increase the average liquidity timeframe of property funds with a liquidity mismatch. Presently, there are 48 property funds with a liquidity mismatch of €6 billion (i.e. the value of property assets that cannot be sold within their current liquidity timeframe). These funds have an average liquidity timeframe of 111 calendar days. If new Guidance were to result in property funds increasing their notification periods to 12 months, all else equal the average liquidity timeframes of these funds would increase to 440 days. It would largely affect property funds that currently have very short liquidity timeframes (see Chart 7). For at least 26 property funds with mismatched property assets of €2.3 billion, a 12-month notification period (in combination with their existing settlement period) would completely remove the current mismatch.<sup>11</sup>

Implementation of the measures is expected to increase the resilience of the property funds.

A leverage limit would increase the sector’s resilience to commercial real estate price falls.

Longer liquidity timeframes would reduce liquidity mismatch.

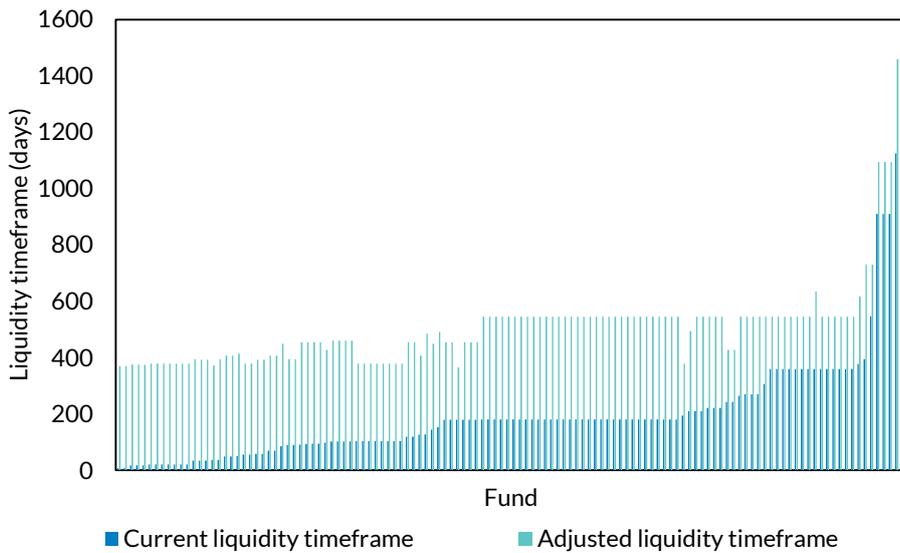
**Table 3: Historical value-at-risk for Irish commercial real estate**

	Year-on-year change in value	Two-year change in value
95 per cent probability	-24.3%	-46.4%
99 per cent probability	-42.6%	-55.1%

Source: Central Bank of Ireland calculations

<sup>11</sup> It is not possible to calculate the impact of a minimum 12-month notification period for the remaining 22 property funds (with a mismatch of €3.7 billion), as the maximum time to sell is not reported in the data.

**Chart 7: Potential impact of 12-month notification periods on liquidity timeframes**



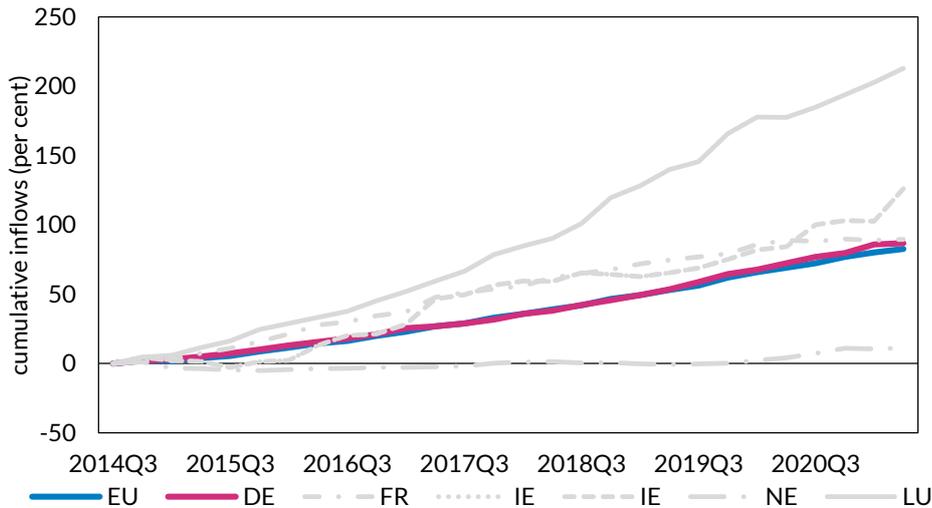
Source: *Deep Dive Survey* and prospectus information.  
 Notes: Data includes 126 property funds with €19 billion in property assets for which information on both liquidity timeframes and property liquidity are available. 'Current liquidity timeframe' = current notification period + current settlement period. 'Adjusted liquidity timeframe' = Minimum 12-month notification period + current settlement period.

**As with all regulatory interventions, these benefits have to be weighed against the potential costs.** The main potential channel that the Central Bank has considered relates to the possible impact of the proposed measures on the volume of CRE investment. In addition, as with any intervention, there is the potential for regulatory arbitrage as an unintended consequence of the proposed measures.

These benefits have to be weighed against the potential costs.

**Evidence from Germany – host of the largest property fund sector in Europe, where similar limits have existed for several years – suggests that flows into property funds have remained robust.** Germany has the largest property fund sector in Europe and has had limits both on leverage (for both retail and professional investor property funds) and minimum notification periods (for retail property funds) for a number of years. Nevertheless, in recent years, flows into property funds in Germany have remained broadly comparable to those in other European jurisdictions (see Chart 8). This points to such limits not having acted as a material constraint on sustainable investment in the CRE market.

**Chart 8: Cumulative net inflows as a percentage of 2014 real estate fund industry size: 2014-2021**



Source: ECB Statistical Data Warehouse, Central Bank of Ireland calculations.

Notes: Data include both UCITs and non-UCITs funds in addition to property funds. Data includes all real estate funds, including those investing in non-domestic real estate and those investing in real estate securities that would not be covered by the proposed regulations in this paper. EU data has a changing composition. Last observation 2021Q2.

Sustainable investment in Irish commercial real estate should continue to provide investors with a desirable return.

**Sustainable investment in Irish CRE should continue to provide investors with a desirable return.** According to MSCI data, Irish yields remain higher than many large European countries as at 2020. For example, over the past 5 years, yields have averaged around 70 basis points higher than in Germany, where despite leverage limitations the property fund sector has grown substantially and continued to see investment. Consequently, while the measures may affect speculative or short-term capital, the Irish property fund sector as a whole would be less vulnerable and more resilient to shocks. More broadly, it is important to note that, while the use of leverage can in some cases increase returns during market upswings, it there is evidence that it also substantially increases losses during downturns.<sup>12</sup> Finally, the proposed limit is not tighter than levels of leverage observed in property funds in other jurisdictions.

**Similarly, it is anticipated that any effect on residential investment would be limited.** Property funds form one part of the private non-household institution sector, which collectively accounted for around €1.6 billion, or 11.1 per cent of total residential real estate transactions in 2020. This €1.6 billion also includes purchases by companies, financial institutions, and other private institutional investors. In terms of their total stock, of the funds surveyed in the Central Bank’s *Deep Dive Survey*, 38 funds (or 21 per cent of property funds) had more than half of their portfolio invested in

<sup>12</sup> For example, see Alcock et al. “[The role of financial leverage in the performance of private equity real estate funds](#)”, *Journal of Portfolio Management* (2013); Baum, Andrew, et al. “[Have property funds performed?](#)”, *Urban Land Institute Europe Policy and Practice Committee Report* (2012); Giacconi et al. “[Leverage and returns: A cross-country analysis of public real estate markets](#)”, *The Journal of Real Estate Finance and Economics* (2015).

residential real estate assets, totalling €3.3 billion. Of this group, the average total loans to total assets ratio was 42 per cent in 2020, compared with 55 per cent for those with no residential property. Funds with significant exposure to residential real estate would therefore be less constrained on average by the proposed leverage limit, relative to those with no residential property. Given the high rental yields in Ireland relative to the rest of Europe, it is expected that the required adjustment would still provide an attractive return for sustainable investment.<sup>13</sup>

**The three-year transition period should limit the impact of adjustment by property funds with higher levels of leverage.** The Central Bank estimates that – as of end-2020, and had the proposed leverage limits been in operation – the property fund sector as a whole would need to replace around €3 billion of debt with equity, without any change in the composition of assets to meet the limits. More than half of that (around €1.7 billion) could be achieved through replacing shareholder loans with equity, which would imply no new net contributions from shareholders. The replacement of shareholder loans with equity is a pattern that has already been occurring in recent years. The remaining estimated €1.3 billion would need to be met through new contributions over a three-year period. By comparison, over the past three years, net subscriptions into the sector have been around €5.6 billion. Overall, the longer transition period would provide more flexibility to funds with existing higher levels of leverage to adjust gradually.

**As with interventions generally, there is the potential for regulatory arbitrage as an additional unintended consequence.** These measures do not apply to unregulated structures investing in Irish CRE. Property funds may therefore decide to restructure their business through unregulated vehicles, or may relocate to alternative jurisdictions in order to avoid the measures. While, in and of itself, this would not be a sufficient reason for not seeking to safeguard the resilience of this form of financing, it could have implications for regulatory effectiveness. The Central Bank will continue to monitor developments in the CRE market as a whole to identify any future sources of systemic risk.

**In general, the policy would bring Irish property funds in line with their European peers.** Currently, Irish property funds have leverage at nearly twice the rate of European property funds on average. Further, a recent ESRB survey indicates that many jurisdictions in Europe have leverage limits on property funds and 10 countries either have ex-ante liquidity measures (such as notification periods) in place or have only closed-ended property funds ([ESRB Non-Bank Financial Intermediation Monitor 2021](#)).

The three-year transition period should limit the impact of any adjustment.

The policy would bring Irish property funds in line with their European peers.

<sup>13</sup> Yields are based on [Catella Real Estate](#) data.

The Central Bank would expect to engage with ESMA and other national competent authorities as part of the leverage assessment process, and would expect to engage with other national competent authorities if cross-border leakages were observed in the future.

## 8. Providing feedback

The Central Bank invites all stakeholders to provide comments on this Consultation Paper and on the draft Guidance that forms part of this Consultation Document. Please provide feedback by filling in the response form, available at this address [www.centralbank.ie/cp145](http://www.centralbank.ie/cp145). The deadline for receiving feedback will be Friday, 18 February 2022.

The Central Bank requests that reasons are given for the responses to all questions answered and that submissions that suggest changes to the proposals in the Consultation Paper be supported, where possible, by evidence, which will aid our consideration of the issues.

The Central Bank intends to make feedback available on its website after the deadline for receiving responses has passed. Please do not include commercially sensitive material in your response, unless you consider it essential. If you do include such material, please highlight it clearly, so that reasonable steps may be taken to avoid publishing that material. This may involve publishing feedback with the sensitive material deleted and indicating the deletions.

While as indicated above, the Central Bank will take reasonable steps to avoid publishing confidential or commercially sensitive material, the Central Bank makes no guarantee that it will not publish any such information and accepts no liability whatsoever for the stakeholders' consultation responses that are subsequently published by the Central Bank. Please be aware that you are making a submission on the basis that you consent to us publishing it in full.

# Annex 1: Draft Guidance on redemption terms for property funds

This Guidance is relevant to Alternative Investment Funds (AIFs) domiciled in Ireland, authorised under domestic legislation, and investing over 50 per cent directly or indirectly in Irish property assets, hereafter termed ‘property funds’.

Regulation 18 of the European Union (Alternative Investment Fund Managers) Regulations (S.I. No. 257/2013) (the Irish AIFM Regulations) requires, inter alia, that an AIFM shall ensure that, for each AIF that it manages, the investment strategy, the liquidity profile and the redemption policy are consistent. In order to further mitigate vulnerabilities stemming from liquidity mismatch in Irish property funds, such AIFMs should take into account the following:

1. Irish property funds would most appropriately be structured as (i) closed ended or (ii) open ended with limited liquidity as per the Central Bank’s AIF Rulebook. During the design phase for such property funds, the Board of the AIFM should carefully consider and document what structure may be most appropriate, taking into account the nature of the assets held, whether a secondary market exists for such assets, and whether redemption requests could be met without recourse to selling large portions of the property fund’s portfolio.
2. Where a property fund is structured as open-ended with limited liquidity, the redemption policies should align with the liquidity profile of the assets. Given the highly illiquid nature of commercial property, the Central Bank expects that the redemption policies of Irish property funds provide for a significant timeframe between the point at which an investor must submit a redemption request for a particular dealing day (notification point) and the point at which investors will expect to receive redemption proceeds from the property fund (settlement point).
3. The Central Bank expects that, in considering their redemption terms, AIFMs take into account the liquidity of property assets under both normal and stressed market conditions. Central Bank research and property fund managers’ own assessments communicated via survey results show that it takes between 6 and 7 months to sell an Irish property asset under normal market

conditions. This timeframe is likely to be higher during periods of market stress and/or if a number of property funds are trying to sell similar assets at the same time.

4. The Central Bank recognises that there are a number of means through which liquidity mismatch in property funds could be mitigated. The Central Bank considers that liquidity management tools are complementary to redemption policies that align with the liquidity profile of a funds' assets. In addition, the Central Bank expects that property funds do not rely excessively on liquid asset buffers to manage liquidity risk, given that this may amplify first-mover advantage dynamics.
5. In that context, the Central Bank expects that property funds have liquidity timeframes (i.e. the total of the notification period plus the settlement period) that explicitly allow for a significant timeframe between the point at which an investor must submit a redemption request for a particular dealing day and the point at which investors will expect to receive redemption proceeds from the fund. The Central Bank would expect that property funds should provide for a liquidity timeframe of at least 12 months, taking into account the nature of the assets held.
6. Such a liquidity timeframe will assist in ensuring that the redemption terms of the property fund align with the liquidity of the assets held in both normal and exceptional circumstances, and in a manner consistent with the fair treatment of investors.
7. The liquidity timeframe should be appropriately balanced between the notification period and the settlement period, reflecting the importance of each. Settlement periods give the property fund time to dispose of property assets in order to limit any impact on market prices. However, the notification period plays an additional role, as it assists the AIFM in appropriately managing redemption requests and provides more time to ensure valuations accurately reflect the price they expect to receive, including under stressed market conditions.
8. The Central Bank expects that those property funds that cannot sell their assets within the minimum timeframe consider having longer liquidity timeframes in place, consistent with Regulation 18 of the Irish AIFM Regulations.
9. The Central Bank would expect AIFMs setting shorter liquidity timeframes in Irish property funds to be able to demonstrate with sufficient evidence, including from periods of stressed market

conditions where liquidity may be strained due to the collective selling activity, that they could sell their assets with no material impact on market prices over that shorter timeframe.



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