Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Macroprudential Policy for the Property Fund Sector – Consultation Paper 145

Feedback from Deloitte Ireland

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:
The ambition to reduce financial risk and volatility in the Irish property sector is clearly a welcome one. However it is important that the measures taken do not have unintended consequences that lead to a reduction in investor appetite for Irish property. Suggested measures are set out below.

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:

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:
Total loan to total asset value limits are too blunt an instrument and

do not adequately reflect the underlying default risk and refinance risk profile of a real estate fund. The following should be considered:

Valuations are an opinion at a point in time and can be misleading when overly or solely relied on.

Debt yield, when used with LTV caps, will be more effective for investment property funds in reducing risk and are in keeping with how the sector itself evaluates leverage risk.

Debt for development purposes is raised on a Loan to Cost basis, then on practical completion the debt is refinanced into investment debt facilities based on debt yield and LTV. Any Loan to Costs ratio would need to take account of the potential occupier risk i.e. is the development speculative, forward sold or pre let. In an environment where we have very high cost inflation, it is critical that leverage caps do not have the effect of making developments unviable.

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:
A total LTV cap at 50% is likely to lead to <40% Effective Leverage (as can be seen in REITs) which will materially impact on equity returns, thereby impacting real estate values. This will have the effect of making Irish CRE less attractive to international capital.

Shareholder loans, when put in place along with third party debt, are typically fully subordinated to the third party debt and have no acceleration rights. Therefore they seldom present a higher level of default risk to the fund than equity.

The requirement for a high debt yield will significantly reduce the risk of high leverage. Suggested revised criteria:

Minimum debt yield of >7.0% for investment property funds

Maximum loan to cost for development asset funds – this should be considered in the context of speculative, pre-sold and pre-let property.

Maximum total LTV including related party debt of 75%, but related party debt must be fully subordinate and have no acceleration rights

Fund must demonstrate an ability to deleverage to <55% LTV for third party debt from internally generated income during the life of the third party debt facilities

This should not cause too much disruption as it is in line with what we are currently seeing from debt providers.

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:
The proposed measures should not be retrospective. However if they are to be, then the proposed adjustment period of 3 years is too short. A period of 5 years should be considered.

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:
Investors require certainty. These proposed measures could, if not decided on quickly, have the effect of creating further uncertainty for potential institutional investors and lead them to invest in other markets. Furthermore, the introduction of leverage limits that can be adjusted during the life of the fund creates additional uncertainty.

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:

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:

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:

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:
If the proposed measures are considered to be overly restrictive by investors it is likely to have the effect of encouraging investment in CRE through unregulated structures rather than regulated structures. This could be counter-productive in reducing risk in the sector.

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.

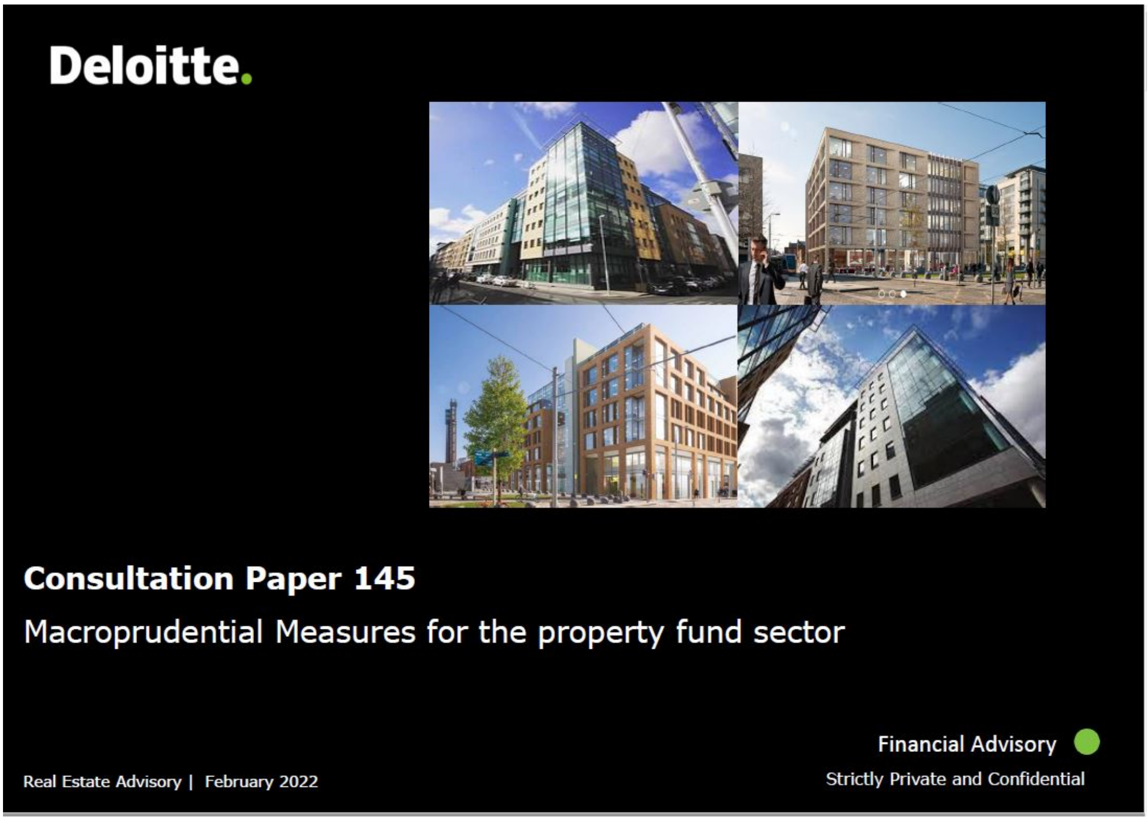
Response:

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:



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Consultation Paper 145

Macroprudential Measures for the property fund sector

Financial Advisory

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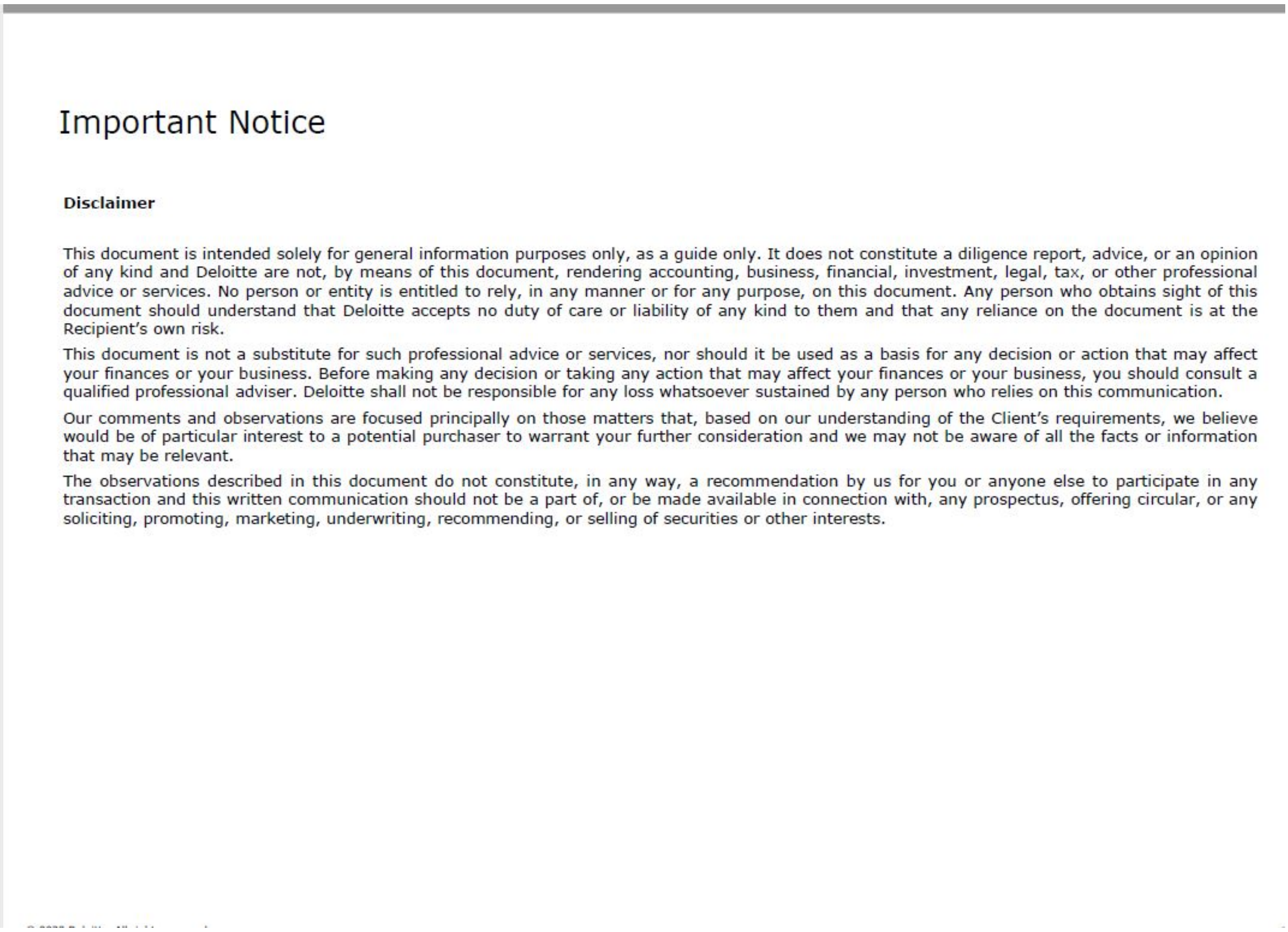
Real Estate Advisory | February 2022



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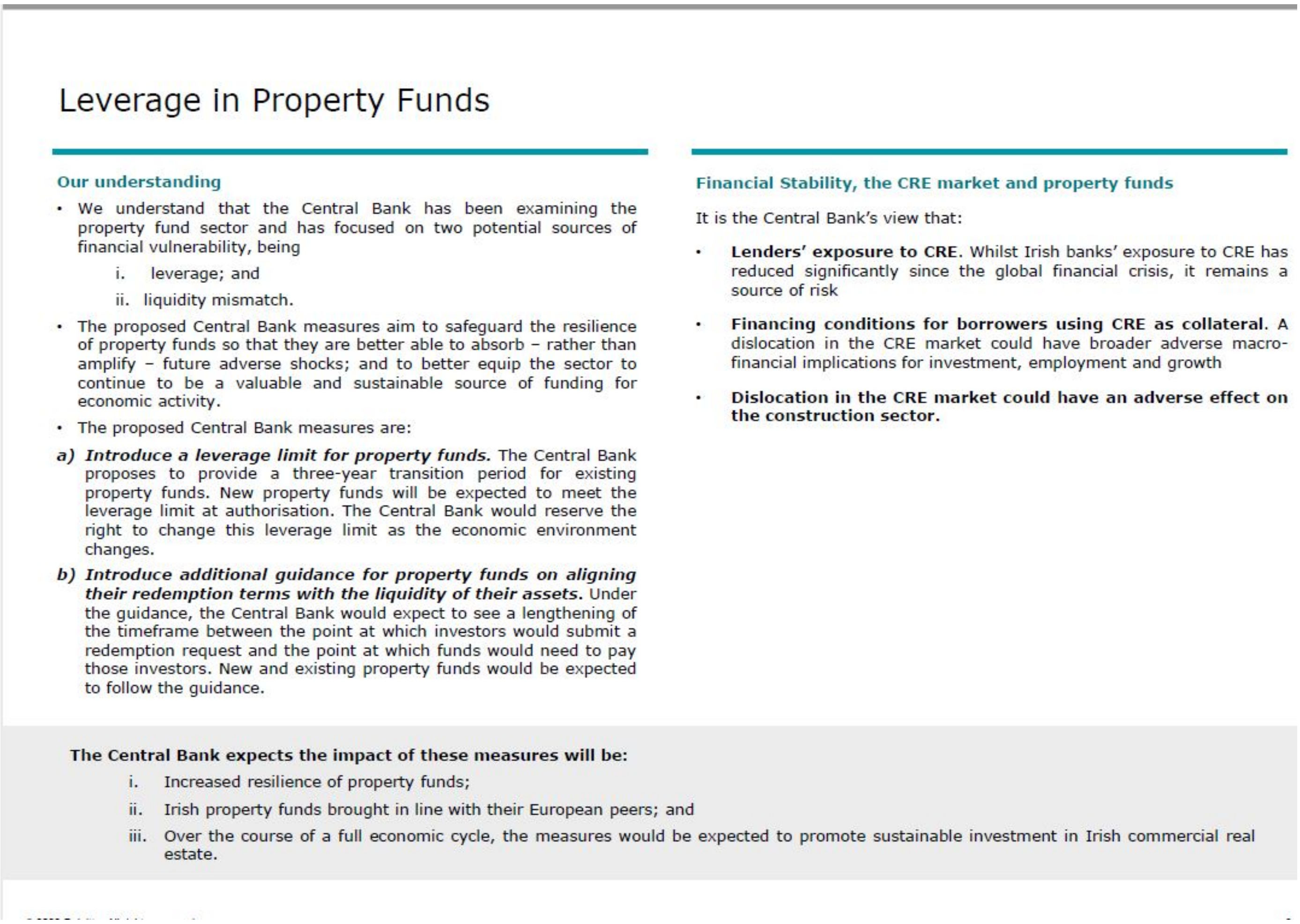


Leverage in Property Funds

Our understanding

- We understand that the Central Bank has been examining the property fund sector and has focused on two potential sources of financial vulnerability, being
  - i. leverage; and
  - ii. liquidity mismatch.
- The proposed Central Bank measures aim to safeguard the resilience of property funds so that they are better able to absorb – rather than amplify – future adverse shocks; and to better equip the sector to continue to be a valuable and sustainable source of funding for economic activity.
- The proposed Central Bank measures are:

a) ***Introduce a leverage limit for property funds.*** The Central Bank proposes to provide a three-year transition period for existing property funds. New property funds will be expected to meet the leverage limit at authorisation. The Central Bank would reserve the right to change this leverage limit as the economic environment changes.

b) ***Introduce additional guidance for property funds on aligning their redemption terms with the liquidity of their assets.*** Under the 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. New and existing property funds would be expected to follow the guidance.

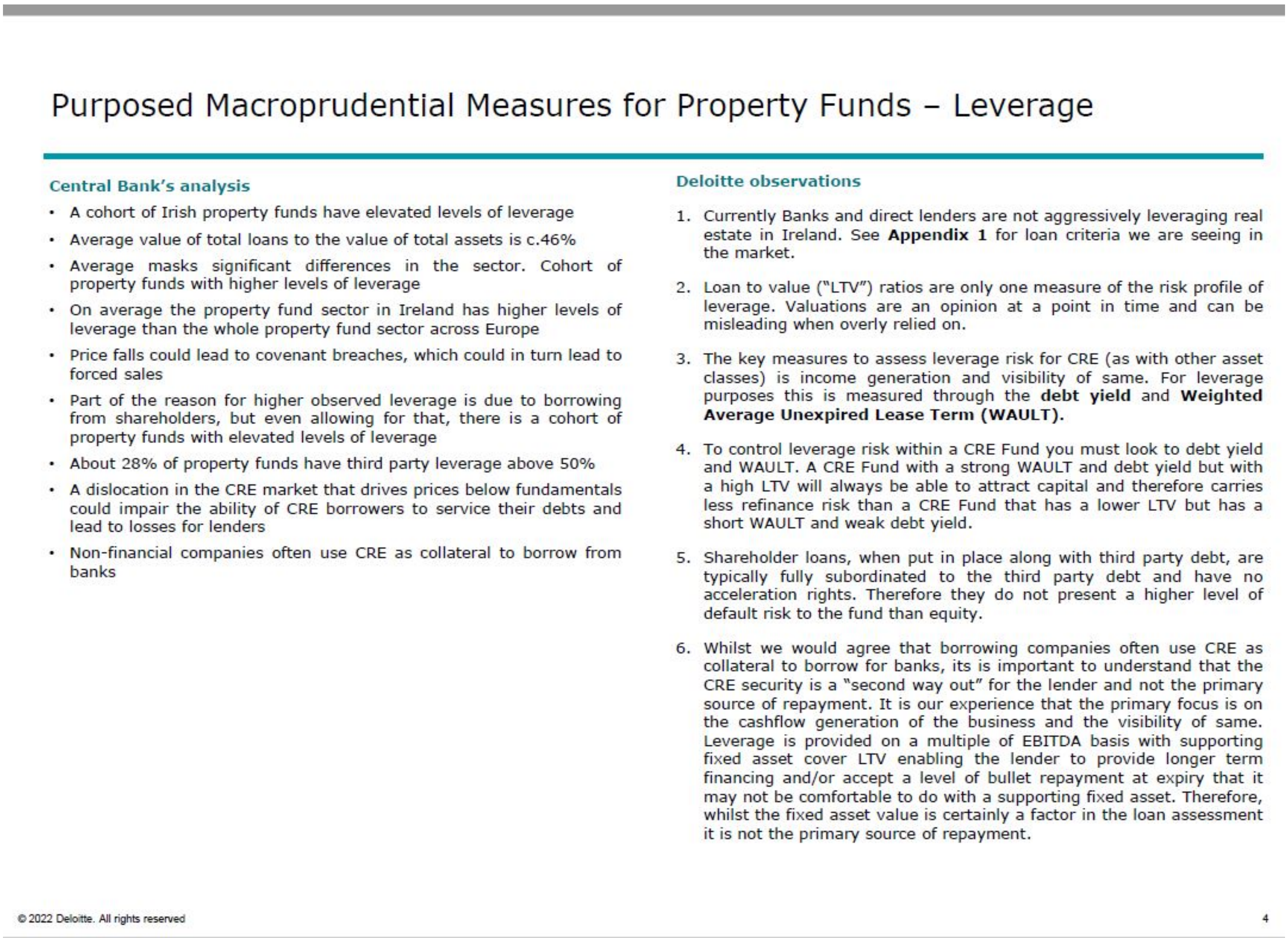
Financial Stability, the CRE market and property funds

It is the Central Bank's view that:

- **Lenders' exposure to CRE.** Whilst Irish banks' exposure to CRE has reduced significantly since the global financial crisis, it remains a source of risk
- **Financing conditions for borrowers using CRE as collateral**. A dislocation in the CRE market could have broader adverse macro-financial implications for investment, employment and growth
- **Dislocation in the CRE market could have an adverse effect on the construction sector.**

The Central Bank expects the impact of these measures will be:

- i. Increased resilience of property funds;
- ii. Irish property funds brought in line with their European peers; and
- iii. Over the course of a full economic cycle, the measures would be expected to promote sustainable investment in Irish commercial real estate.



Purposed Macroprudential Measures for Property Funds – Leverage

Central Bank's analysis

- A cohort of Irish property funds have elevated levels of leverage
- Average value of total loans to the value of total assets is c.46%
- Average masks significant differences in the sector. Cohort of property funds with higher levels of leverage
- On average the property fund sector in Ireland has higher levels of leverage than the whole property fund sector across Europe
- Price falls could lead to covenant breaches, which could in turn lead to forced sales
- Part of the reason for higher observed leverage is due to borrowing from shareholders, but even allowing for that, there is a cohort of property funds with elevated levels of leverage
- About 28% of property funds have third party leverage above 50%
- 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
- Non-financial companies often use CRE as collateral to borrow from banks

Deloitte observations

1. Currently Banks and direct lenders are not aggressively leveraging real estate in Ireland. See **Appendix 1** for loan criteria we are seeing in the market.
2. Loan to value ("LTV") ratios are only one measure of the risk profile of leverage. Valuations are an opinion at a point in time and can be misleading when overly relied on.
3. The key measures to assess leverage risk for CRE (as with other asset classes) is income generation and visibility of same. For leverage purposes this is measured through the **debt yield** and **Weighted Average Unexpired Lease Term (WAULT).**
4. To control leverage risk within a CRE Fund you must look to debt yield and WAULT. A CRE Fund with a strong WAULT and debt yield but with a high LTV will always be able to attract capital and therefore carries less refinance risk than a CRE Fund that has a lower LTV but has a short WAULT and weak debt yield.
5. Shareholder loans, when put in place along with third party debt, are typically fully subordinated to the third party debt and have no acceleration rights. Therefore they do not present a higher level of default risk to the fund than equity.
6. Whilst we would agree that borrowing companies often use CRE as collateral to borrow for banks, its is important to understand that the CRE security is a "second way out" for the lender and not the primary source of repayment. It is our experience that the primary focus is on the cashflow generation of the business and the visibility of same. Leverage is provided on a multiple of EBITDA basis with supporting fixed asset cover LTV enabling the lender to provide longer term financing and/or accept a level of bullet repayment at expiry that it may not be comfortable to do with a supporting fixed asset. Therefore, whilst the fixed asset value is certainly a factor in the loan assessment it is not the primary source of repayment.

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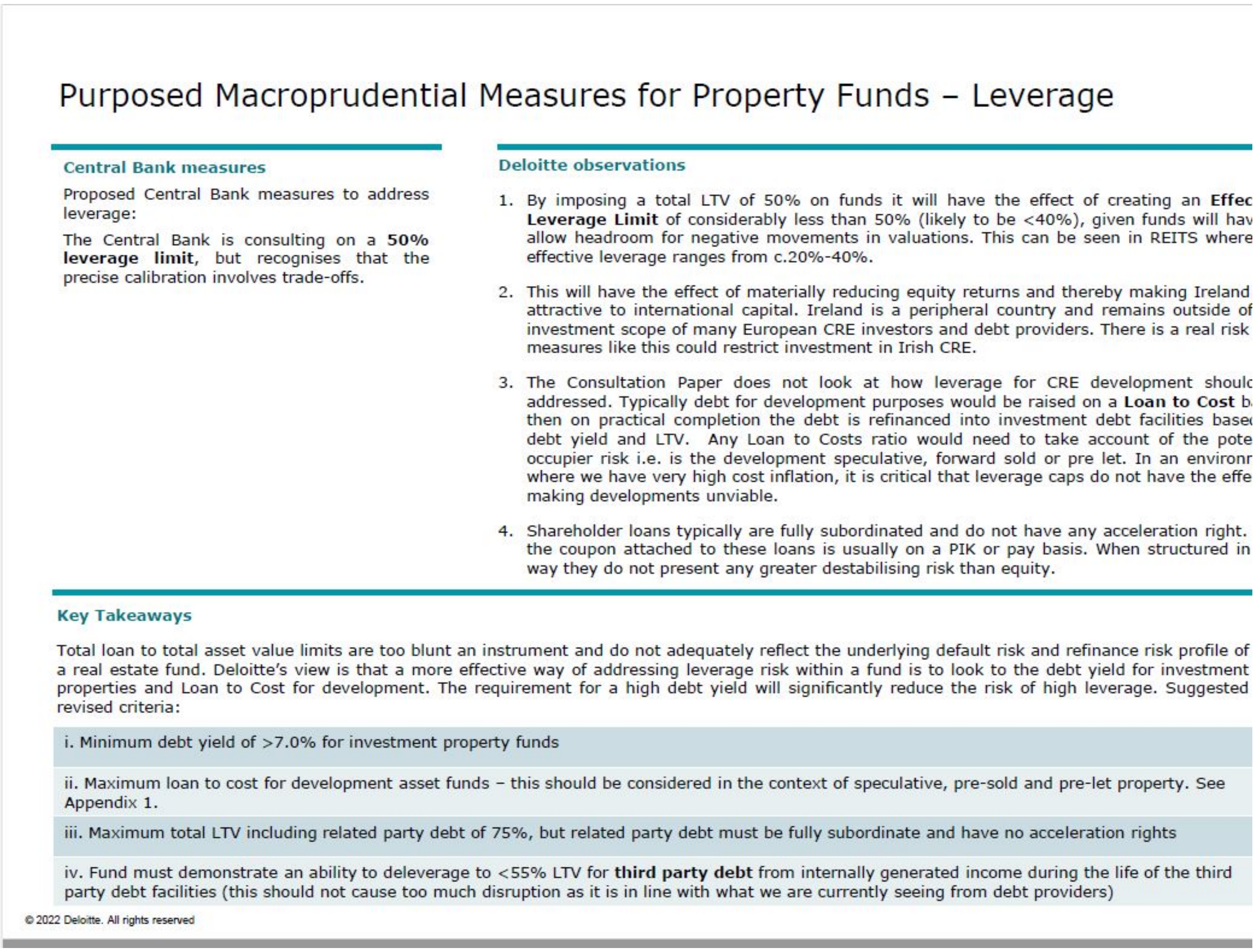

Purposed Macroprudential Measures for Property Funds – Leverage

Central Bank measures

Proposed Central Bank measures to address leverage:

The Central Bank is consulting on a **50% leverage limit**, but recognises that the precise calibration involves trade-offs.

Deloitte observations

1. By imposing a total LTV of 50% on funds it will have the effect of creating an **Effec Leverage Limit** of considerably less than 50% (likely to be <40%), given funds will hav allow headroom for negative movements in valuations. This can be seen in REITS where effective leverage ranges from c.20%-40%.
2. This will have the effect of materially reducing equity returns and thereby making Ireland attractive to international capital. Ireland is a peripheral country and remains outside of investment scope of many European CRE investors and debt providers. There is a real risk measures like this could restrict investment in Irish CRE.
3. The Consultation Paper does not look at how leverage for CRE development shoulc addressed. Typically debt for development purposes would be raised on a **Loan to Cost** b then on practical completion the debt is refinanced into investment debt facilities basec debt yield and LTV. Any Loan to Costs ratio would need to take account of the pote occupier risk i.e. is the development speculative, forward sold or pre let. In an environr where we have very high cost inflation, it is critical that leverage caps do not have the effe making developments unviable.
4. Shareholder loans typically are fully subordinated and do not have any acceleration right. the coupon attached to these loans is usually on a PIK or pay basis. When structured in way they do not present any greater destabilising risk than equity.

Key Takeaways

Total loan to total asset value limits are too blunt an instrument and do not adequately reflect the underlying default risk and refinance risk profile of a real estate fund. Deloitte's view is that a more effective way of addressing leverage risk within a fund is to look to the debt yield for investment properties and Loan to Cost for development. The requirement for a high debt yield will significantly reduce the risk of high leverage. Suggested revised criteria:

i. Minimum debt yield of >7.0% for investment property funds

ii. Maximum loan to cost for development asset funds – this should be considered in the context of speculative, pre-sold and pre-let property. See Appendix 1.

iii. Maximum total LTV including related party debt of 75%, but related party debt must be fully subordinate and have no acceleration rights

iv. Fund must demonstrate an ability to deleverage to <55% LTV for **third party debt** from internally generated income during the life of the third party debt facilities (this should not cause too much disruption as it is in line with what we are currently seeing from debt providers)

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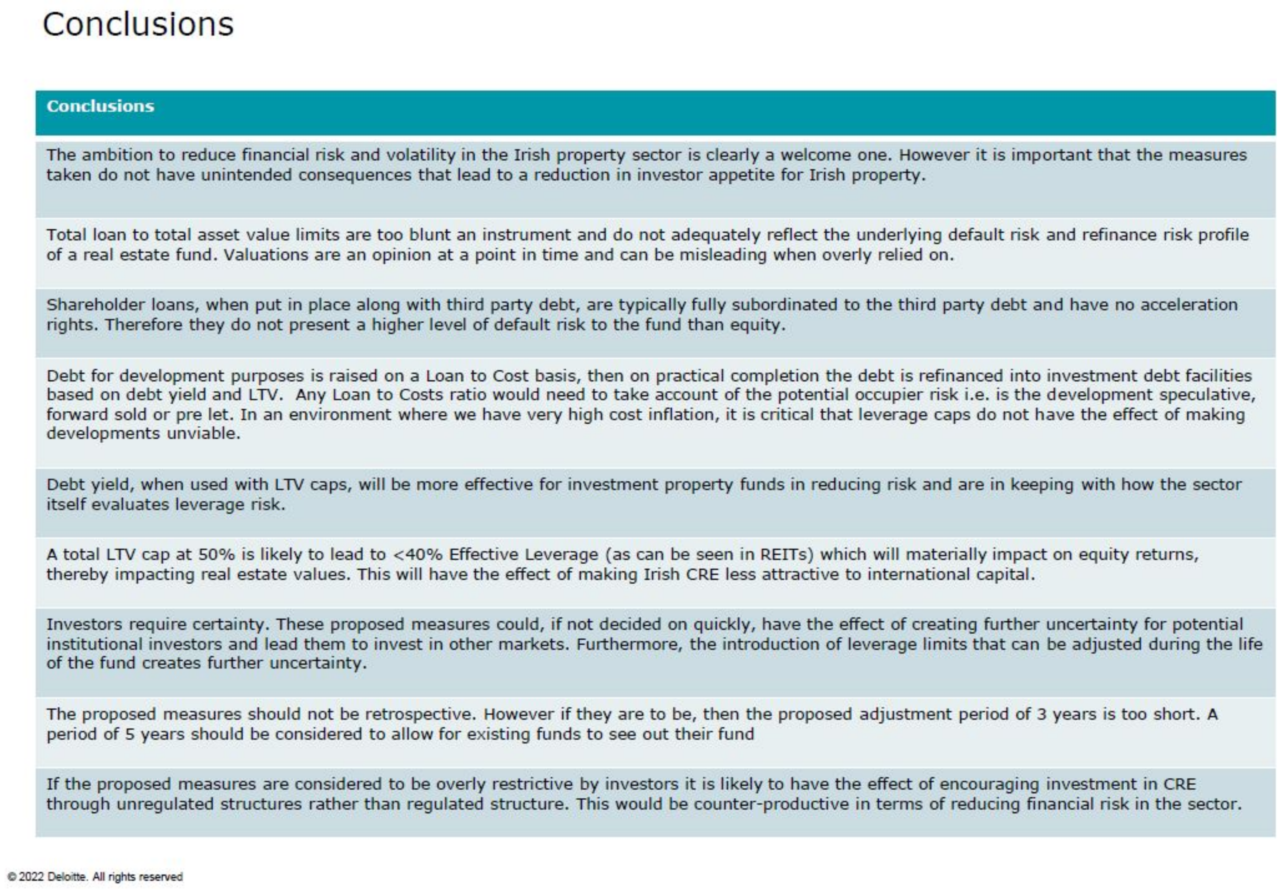

Conclusions

Conclusions
The ambition to reduce financial risk and volatility in the Irish property sector is clearly a welcome one. However it is important that the measures taken do not have unintended consequences that lead to a reduction in investor appetite for Irish property.
Total loan to total asset value limits are too blunt an instrument and do not adequately reflect the underlying default risk and refinance risk profile of a real estate fund. Valuations are an opinion at a point in time and can be misleading when overly relied on.
Shareholder loans, when put in place along with third party debt, are typically fully subordinated to the third party debt and have no acceleration rights. Therefore they do not present a higher level of default risk to the fund than equity.
Debt for development purposes is raised on a Loan to Cost basis, then on practical completion the debt is refinanced into investment debt facilities based on debt yield and LTV. Any Loan to Costs ratio would need to take account of the potential occupier risk i.e. is the development speculative, forward sold or pre let. In an environment where we have very high cost inflation, it is critical that leverage caps do not have the effect of making developments unviable.
Debt yield, when used with LTV caps, will be more effective for investment property funds in reducing risk and are in keeping with how the sector itself evaluates leverage risk.
A total LTV cap at 50% is likely to lead to <40% Effective Leverage (as can be seen in REITs) which will materially impact on equity returns, thereby impacting real estate values. This will have the effect of making Irish CRE less attractive to international capital.
Investors require certainty. These proposed measures could, if not decided on quickly, have the effect of creating further uncertainty for potential institutional investors and lead them to invest in other markets. Furthermore, the introduction of leverage limits that can be adjusted during the life of the fund creates further uncertainty.
The proposed measures should not be retrospective. However if they are to be, then the proposed adjustment period of 3 years is too short. A period of 5 years should be considered to allow for existing funds to see out their fund
If the proposed measures are considered to be overly restrictive by investors it is likely to have the effect of encouraging investment in CRE through unregulated structures rather than regulated structure. This would be counter-productive in terms of reducing financial risk in the sector.

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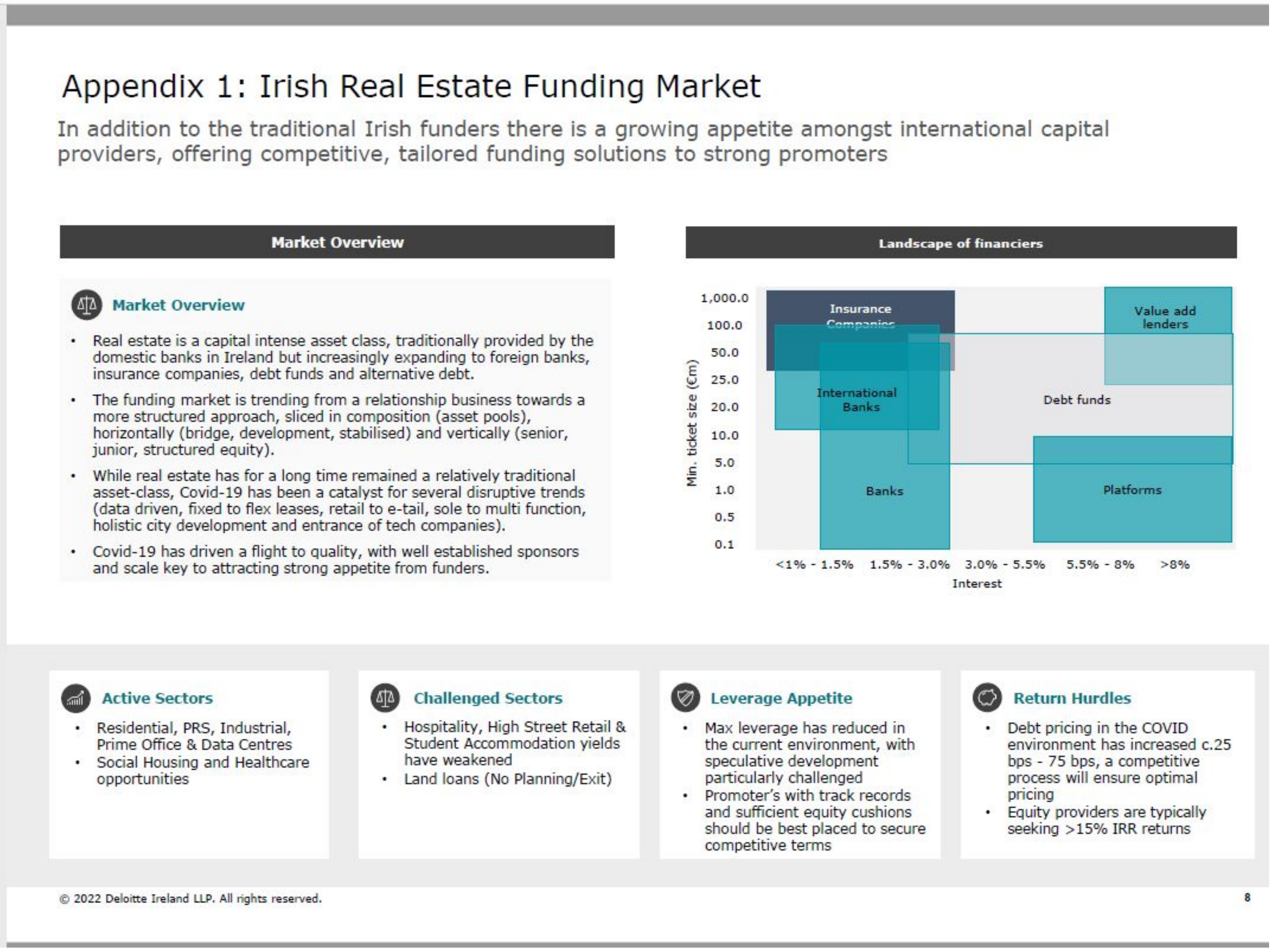
Appendix 1



Appendix 1: Irish Real Estate Funding Market

In addition to the traditional Irish funders there is a growing appetite amongst international capital providers, offering competitive, tailored funding solutions to strong promoters

Market Overview

Market Overview

- Real estate is a capital intense asset class, traditionally provided by the domestic banks in Ireland but increasingly expanding to foreign banks, insurance companies, debt funds and alternative debt.
- The funding market is trending from a relationship business towards a more structured approach, sliced in composition (asset pools), horizontally (bridge, development, stabilised) and vertically (senior, junior, structured equity).
- While real estate has for a long time remained a relatively traditional asset-class, Covid-19 has been a catalyst for several disruptive trends (data driven, fixed to flex leases, retail to e-tail, sole to multi function, holistic city development and entrance of tech companies).
- Covid-19 has driven a flight to quality, with well established sponsors and scale key to attracting strong appetite from funders.

Landscape of financiers

Active Sectors

- Residential, PRS, Industrial, Prime Office & Data Centres
- Social Housing and Healthcare opportunities

Challenged Sectors

- Hospitality, High Street Retail & Student Accommodation yields have weakened
- Land loans (No Planning/Exit)

Leverage Appetite

- Max leverage has reduced in the current environment, with speculative development particularly challenged
- Promoter's with track records and sufficient equity cushions should be best placed to secure competitive terms

Return Hurdles

- Debt pricing in the COVID environment has increased c.25 bps - 75 bps, a competitive process will ensure optimal pricing
- Equity providers are typically seeking >15% IRR returns

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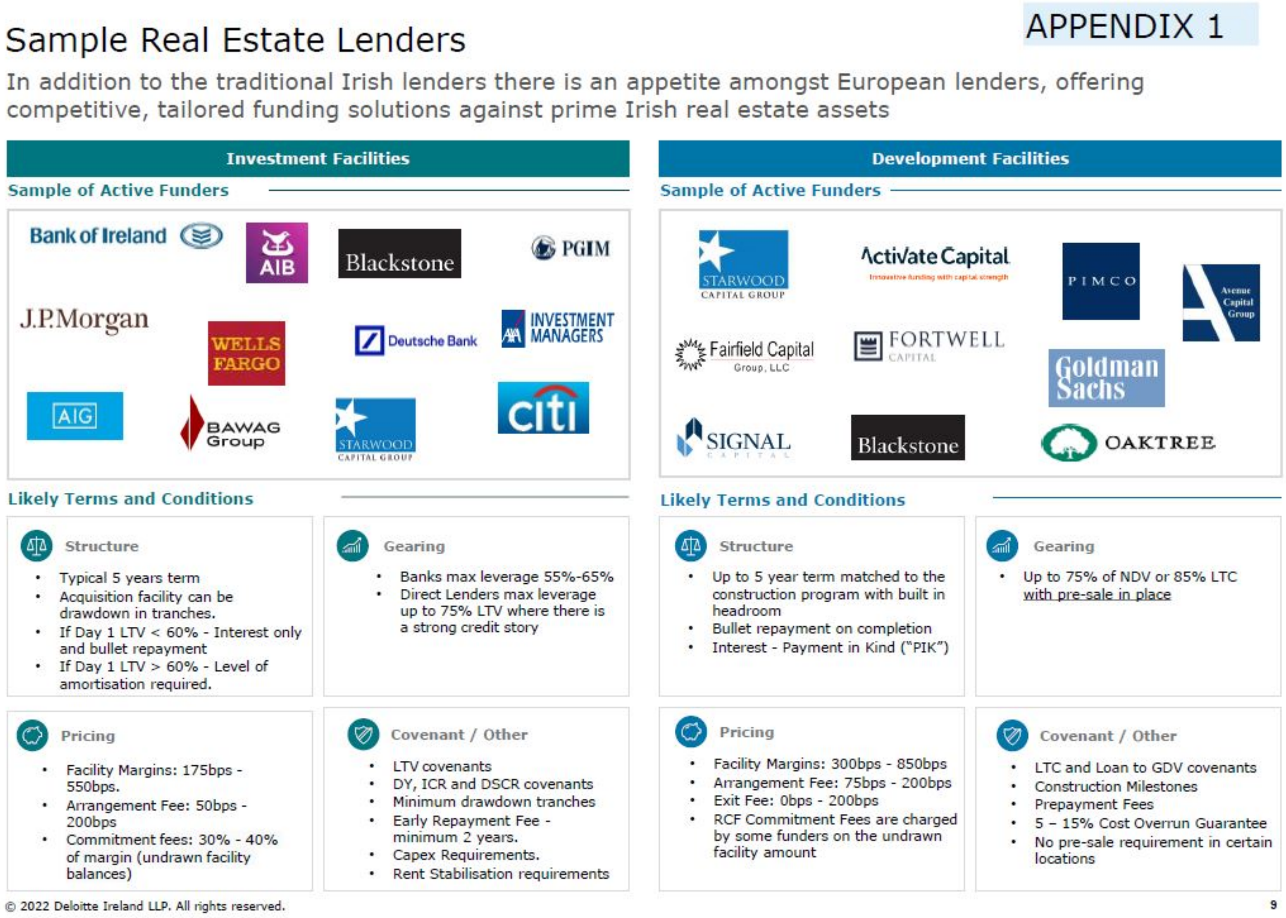

APPENDIX 1

Sample Real Estate Lenders

In addition to the traditional Irish lenders there is an appetite amongst European lenders, offering competitive, tailored funding solutions against prime Irish real estate assets

Investment Facilities

Sample of Active Funders

- Bank of Ireland
- AIB
- Blackstone
- PGIM
- J.P.Morgan
- Wells Fargo
- Deutsche Bank
- AXA Investment Managers
- AIG
- BAWAG Group
- Starwood Capital Group
- citi

Likely Terms and Conditions

Structure

- Typical 5 years term
- Acquisition facility can be drawndown in tranches.
- If Day 1 LTV < 60% - Interest only and bullet repayment
- If Day 1 LTV > 60% - Level of amortisation required.

Gearing

- Banks max leverage 55%-65%
- Direct Lenders max leverage up to 75% LTV where there is a strong credit story

Pricing

- Facility Margins: 175bps - 550bps.
- Arrangement Fee: 50bps - 200bps
- Commitment fees: 30% - 40% of margin (undrawn facility balances)

Covenant / Other

- LTV covenants
- DY, ICR and DSCR covenants
- Minimum drawdown tranches
- Early Repayment Fee - minimum 2 years.
- Capex Requirements.
- Rent Stabilisation requirements

Development Facilities

Sample of Active Funders

- Starwood Capital Group
- ActiVate Capital – Innovative funding with capital strength
- PIMCO
- Avenue Capital Group
- Fairfield Capital Group, LLC
- Fortwell Capital
- Goldman Sachs
- Signal Capital
- Blackstone
- Oaktree

Likely Terms and Conditions

Structure

- Up to 5 year term matched to the construction program with built in headroom
- Bullet repayment on completion
- Interest - Payment in Kind ("PIK")

Gearing

- Up to 75% of NDV or 85% LTC with pre-sale in place

Pricing

- Facility Margins: 300bps - 850bps
- Arrangement Fee: 75bps - 200bps
- Exit Fee: 0bps - 200bps
- RCF Commitment Fees are charged by some funders on the undrawn facility amount

Covenant / Other

- LTC and Loan to GDV covenants
- Construction Milestones
- Prepayment Fees
- 5 – 15% Cost Overrun Guarantee
- No pre-sale requirement in certain locations

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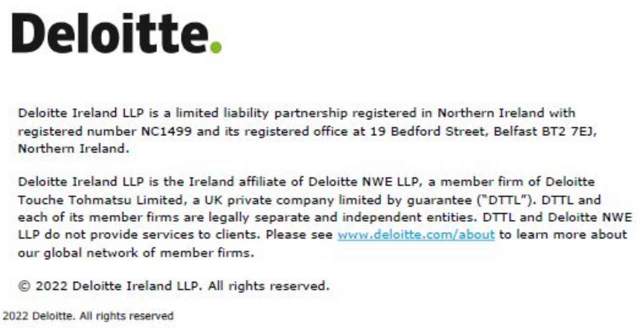

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If you have any further thoughts or considerations on the proposals outlined in Consultation Paper 145, please share them below.

T: +353 (0)1 224 5800
E: publications@centralbank.ie
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