Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Feedback Statement – Consultation Paper 145: Macroprudential measures for the property fund sector

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Feedback Statement: Macroprudential measures for the property fund sector

In 2021, the Central Bank proposed the introduction of macroprudential limits on leverage and Central Bank Guidance to limit liquidity mismatch for Irish-authorised property funds. The proposed policies aim 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 as a sustainable source of funding for economic activity.

1. Introduction

The Central Bank of Ireland's (the Central Bank's) consultation paper (CP145) on macroprudential measures for the Irish property fund sector outlined the Central Bank's proposal to introduce macroprudential measures to limit total debt-to-total assets (hereafter the "leverage limit") and liquidity mismatch in Irish-authorised property funds (hereafter termed 'property funds').[1] Stakeholders were invited to provide feedback on the proposals. Twenty responses were received from stakeholders, including alternative investment fund managers (AIFMs), fund investors, alternative investment fund (AIF) service providers, and a range of industry bodies, over a 12-week consultation period from 25 November 2021 to 18 February 2022.

The Central Bank would like to thank all stakeholders who took the time to make a submission on CP145. The insights provided by the

[1] Reflecting the macroprudential objective of the measures, the measures will apply to Alternative Investment Fund Managers ("AIFMs") of Alternative Investment Funds ("AIFs") that are domiciled in Ireland, authorised under domestic legislation, and investing fifty 50 per cent or more directly or indirectly in Irish property assets. For further details on the scope of the measures see the *Central Bank's Macroprudential Policy Framework for Irish Property Funds*

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feedback have fed-into the Central Bank's deliberations around the calibration and implementation of the proposed measures.

While the feedback was wide-ranging, the majority related to a fixed number of topics. In the case of leverage, these included: 1) the definition of property funds in-scope; 2) the measure of leverage; 3) the use of a single limit; 4) the level of the leverage limit; 5) the approach to counter-cyclicality; 6) the implementation period; and 7) the potential for unintended consequences. In the case of the Guidance on liquidity timeframes (hereafter referred to as the 'Guidance'), the key issues were 1) the coverage of the Guidance; and 2) the length of the liquidity timeframe.

The core elements of the measures as put forward in CP145 are being retained in the final policy measures. Nevertheless, reflecting the feedback received, and based on further analysis, the Central Bank has judged that it is appropriate to make certain adjustments to the original proposals as follows (more details on these changes are provided in the accompanying *Central Bank's Macroprudential Policy Framework for Irish Property Funds* (hereafter referred to as the 'Policy Document'):

- Recognising that funds may seek to operate in practice with a buffer below the leverage limit to provide capacity to avoid breaches due to normal market movements, the Central Bank has decided that the leverage limit will be set at sixty per cent, instead of fifty per cent.
- In the case of the leverage limit, the Central Bank is extending the implementation period from three years to five years to allow for the gradual and orderly adjustment of leverage in existing property funds. The Central Bank expects that funds will make early and steady progress towards lower leverage levels over the implementation period. It is expected that existing property funds with leverage levels above the limit would not increase the quantum of their debt during the implementation period. The Central Bank will only authorise new funds if they meet the sixty per cent leverage limit.
- Property funds that hold at least eighty percent of their total assets under management in social housing (hereafter referred to as 'social housing funds') will not be considered in scope for

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the leverage limits provided they satisfy a number of criteria (outlined in further detail in the Policy Document). Social housing funds collectively represent a lower systemic risk as the likelihood of forced sales in these funds is deemed considerably less than other property funds.

- Property funds that borrow on a loan-to-cost ('LTC') basis to fund development activities can use a different methodological framework for the purpose of calculating leverage on those assets. This is a methodological accommodation for development activities, reflecting the fact that the cost-based valuation does not account for the value added of a completed asset that development activity generates. Once a development asset becomes an investment asset, the standard calculation framework in-line with the sixty per cent leverage limit applies. (See the Policy Document for further details on this method).
- Subject to prudent liquidity management by the fund manager, the liquidity timeframe may not be required where (i) the designation of a redemption dealing day is at the discretion of Directors (and not at the option of investors) and (ii) the property fund has sufficient liquid assets not generated by disposal of Irish property assets for the purpose of funding the redemption.

This Feedback Statement summarises the material responses received to CP145. The Feedback Statement is structured such that the general feedback on leverage limits and liquidity timeframes is addressed first, with the remaining feedback on specific aspects of the proposals presented subsequently.

The Feedback Statement is published to promote an understanding of the policy development process within the Central Bank and is not relevant to assessing compliance with regulatory requirements. For further details on the final package of macroprudential policy measures, along with the key principles and elements of the framework, please see the Policy Document.

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2. General feedback

2.1 Leverage limits

To guard against excessive levels of leverage across the property fund sector, the Central Bank proposed to introduce a limit on the ratio of property funds' total debt to their total assets. The proposed leverage limit would be imposed using Regulation 26 of the Irish AIFM Regulations, in line with ESMA guidelines.

Feedback

Most respondents opposed the introduction of a leverage limit. In particular, a large number of respondents noted that a reduction in leverage may reduce the anticipated internal rate of return on investment.

The following summarises the areas of most common concern among respondents in relation the concept of a leverage limit (more specific feedback on the application of the leverage limit proposal is outlined in Section 3).

- Many respondents considered the resilience of the sector to be sufficient, particularly given the lower levels of leverage than before the global financial crisis (GFC) and the response of the sector to COVID-19. Some respondents argued that qualifying investors were able to appropriately judge the risks they were being exposed to via investing in the fund.

- The majority of respondents suggested that they would be unable to comply with the regulations over any timeframe, as they would not be able to access additional capital or restructure their borrowing arrangements. This could, in the view of respondents, lead to forced sales, potentially destabilising the CRE market.

- Many respondents argued that a leverage limit would be ineffective at supporting prices in the CRE market, as funds represent too-small a share of that market.

- The utilisation of a leverage limit was seen as increasing uncertainty to the Irish property fund sector and its investors, leading to reputational damage and withdrawal from the market.

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- The regulation was considered by many respondents to be retrospective and a preference was indicated for the 'grandfathering' of existing funds. There was some concern that the regulation would represent a 'material change to the current regulatory framework.'

- Respondents stated that the leverage limit would make investment in Irish property through property funds uncompetitive. They noted that investors would be more likely to use unregulated vehicles, or cease to invest in Irish property. The potential impact on the development of new residential housing in particular was noted by some respondents.

Some respondents suggested that the Central Bank should gather and publish additional data on the commercial property market as an alternative to the limit. It was also suggested that leverage limits could be tailored and applied at the EU level.

Practical questions were also raised regarding what is 'regular reporting' for AIFMD purposes, and around valuation and the calculation of metrics.

Central Bank Response:

The objective of the leverage limit is to guard against the risk that a shock to the CRE market could be amplified via investment funds' use of high levels of leverage, and thereby transmitted to other parts of the economy. The systemic risk arises from the collective impact of actions that highly-leveraged funds may take in response to an adverse shock. These actions often can be individually-rational, but entail externalities for the CRE market and the broader economy. The goal of the proposed measures is <u>not</u> to target CRE prices.

The Central Bank acknowledges the resilience of the sector through the COVID-19 shock and that this risk has not materialised to date. However, the absence of any adverse reaction in the CRE sector to the COVID-19 shock is not necessarily a guide to how the sector may react to future macro-financial shocks, the features, impacts and duration of which may all be different. For example, there were significant government, central bank, and international institution supports in place

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through the COVID-19 shock that indirectly supported markets and which may not be available in future shocks.

The Central Bank notes respondents' points regarding the limited ability to undertake additional capital raising to reduce their leverage. To the degree that this is the case even in relatively benign periods, this would imply extremely limited options to manage leverage in times of stress. In turn, this raises the likelihood of shocks to the sector leading to forced sales and knock-on effects, and serves to highlight the potential for systemic risk arising from very high levels of leverage in this industry. This increases the need for the Central Bank to take early action to reduce the likelihood of these dynamics from arising.

The Central Bank recognises that the measures may have some impact on more speculative investment. However, fund investments that depend on very high levels of leverage are likely to prove very volatile, with their collective activities posing a higher risk to the stability of the Irish financial system and the broader economy. Funds that meet the leverage limit are more likely to provide a sustainable source of long-term capital and less likely to contribute to systemic risk. In doing so, the leverage limit supports the resilience of the overall sector and Irish economy. Further, in the Central Bank's view, this outcome cannot be achieved through the provision of data alone as an alternative.

Regulation 26 of the Irish AIFM Regulations forms part of the existing regulatory framework. From 2022, ESMA requires all national competent authorities (NCAs) in the Europe Union (EU) to conduct an assessment of fund leverage for *all AIFs* and to apply leverage limits to those funds whose use of leverage may constitute a systemic risk, in accordance with their Guidelines. NCAs are only required to notify funds of the leverage limit once the assessment process is complete. By engaging with the industry ahead of the assessment process, and by establishing a clear and comprehensive policy approach, the Central Bank is seeking to reduce any uncertainty with respect to the imposition of leverage limits under Regulation 26 of the Irish AIFM Regulations for property funds.

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The AIF Rulebook contains provisions that, in a given context, prevent a property fund from making material changes to its investment policy without prior investor approval. Certain respondents have suggested that the new leverage limit introduced under Regulation 26 of the AIFM Regulations would constitute a material change of investment policy of an in-scope AIF for the purposes of the AIF Rulebook. The Central Bank believes that the implementation of macro-prudential measures, which are designed to ensure the stability and integrity of the financial system (which in turn protects the interest of investors), does not contradict the investor protection measures outlined in its AIF Rulebook. In this regard, the Central Bank is providing a five-year implementation period for that limit from 24 November 2022 to 24 November 2027, to allow for completion of any necessary steps. The Guidance provides for an implementation time-frame of 18 months, from 24 November 2022 to 24 May 2024.

2.2 Guidance on liquidity timeframes

The Central Bank proposed additional Guidance with respect to how Regulation 18 of the Irish AIFM Regulations should be applied in the case of property funds, with a view to better aligning redemption terms with the liquidity of assets.

Feedback

Responses to the Guidance on liquidity mismatch were mixed. Not all responses provided feedback on the Guidance, but of those responses that did, some were fully supportive, others opposed, and some suggested potential amendments.

The following issues were raised by respondents.

- Several respondents argued that liquidity mismatch should be dealt with at EU-level.
- Some respondents argued that available liquidity management tools (LMTs) (especially given the European Commission review of EU rules on alternative investment fund managers) are sufficient to manage liquidity issues. Some respondents

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suggested more use of LMTs, such as side pockets or liquidity buffers.

- Some respondents argued that funds should be able to use discretionary manager deferrals of redemption requests to manage liquidity risk, rather than having a fixed liquidity timeframe.

Additional requests were made to: extend the Guidance to unit-linked funds; provide Guidance that covers the full range of illiquid assets; and provide Guidance on suspending redemptions in the event of material uncertainty clauses in valuations.

Central Bank Response:

The AIFMD requires that funds align their redemption policies, liquidity timeframes, and asset liquidity. Reflecting the current diversity of approaches taken by Irish property funds in interpreting this regulation, it is the role of the Central Bank as the Irish NCA to issue Guidance to ensure that these different approaches do not lead to the build-up of systemic risk in the property funds sector, particularly if investors perceive property funds to be more liquid than is actually the case.

While the Central Bank supports the appropriate use of LMTs that aim to pass on liquidity costs to redeeming investors, these are not substitutes for the alignment of redemption terms with the liquidity of the assets and cannot address liquidity mismatch in funds investing in inherently illiquid assets such as property *ex ante*. For instance, in the case of funds investing in property, passing on liquidity costs to redeeming investors is particularly challenging. It is important that these LMTs be supplemented with measures to improve resilience through the cycle, such as the notification and settlement periods outlined in the Guidance.

The Central Bank acknowledges that there are some circumstances where the liquidity timeframe may not be required. In particular, and subject to prudent liquidity management by the fund manager, the liquidity timeframe may not be required where (i) the designation of a redemption dealing day is at the discretion of Directors (and not at the option of investors) and (ii) the property

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fund has sufficient liquid assets not generated by disposal of Irish property assets for the purpose of funding the redemption.

Unit-linked funds are subject to separate regulation as part of the insurance sector. In some cases unit-linked funds invest in real estate indirectly, via property funds. In those cases, the property sub-fund will be covered by the proposed policies.

3. Specific feedback: Leverage limits

3.1 Definition of property funds

CP145 defines property funds as AIFs domiciled in Ireland, authorised under domestic legislation, and investing over fifty per cent directly or indirectly in Irish CRE assets.

Feedback

There was some support for the definition of property funds, and some opposition. Some questions were raised regarding the clarity of the definition. In particular more clarity was requested on:

- Whether the ESRB definition includes social housing funds;
- Whether Irish property assets are the same as Irish CRE;
- Whether development properties were included as CRE; and
- What is meant by an 'indirect' holding.

Relatedly, several requests for exclusions were made, including:

- All existing funds;
- Closed-ended funds;
- Social housing funds;
- Residential real estate;
- Development loans; and
- The non-real estate segment of mixed funds.

Central Bank Response:

All Irish property assets held directly by Irish-authorised funds meet the ESRB definition of CRE and, as such, all Irish-authorised funds investing over fifty per cent of their assets under

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management in such assets would be fully covered by the measures.

Specifically, the policies would apply to Alternative Investment Managers ("AIFMs") of Alternative Investment Funds ("AIFs") that are domiciled in Ireland, authorised under domestic legislation, and investing fifty per cent or more directly or indirectly in Irish property assets.

The measures will cover both direct and indirect exposures to Irish property assets. Directly held assets refers to on-balance sheet holdings of real estate. An indirectly held property asset includes any investment undertaken by the property fund that gives exposure to, or which holds, Irish property assets. A non-exhaustive list of mechanisms used to achieve indirect exposure to Irish property assets includes use of a special purpose entity (SPE) or similar vehicle; partnership arrangements; or investment in other funds that hold Irish property assets. This definition excludes exposure to Irish property assets through equities, debt instruments and derivatives, where those instruments are (1) traded on regulated trading venue; and (2) where the underlying Irish property asset is controlled by a party that is independent of the property fund, the AIFM and/or its delegates and its investors. This definition may be subject to revision if circumvention of these rules via technical means is identified.

In March 2019 the ESRB proposed a new delineation for CRE (ESRB/2019/3). This aligned the previous delineation of CRE (ESRB/2016/14) with the Capital Requirements Regulation (CRR) (Regulation (EU) No 575/2013). Accordingly, CRE is now defined as any income-producing real estate asset, either existing or under development, including social housing, property owned by end-users, and rental housing.

With regards to exclusions, and in line with the macroprudential goals of the policy, it is noted under the ESMA guidelines that: "Where competent authorities determine that a group of AIFs of the same type and similar risk profiles may collectively pose leverage-related systemic risks, they should apply leverage limits in a similar or identical manner to all AIFs in that group of AIFs." As such, any exclusions would need to be made on the grounds of a

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different (lower) chance of systemic risk arising from the entity type.

In line with the above ESMA guidelines, the Central Bank has assessed that social housing funds (subject to certain criteria) do pose lower systemic risk as the likelihood of forced asset sales is deemed to be considerably less than in other property funds. As such, social housing funds will not be in scope for the leverage limits.

The Central Bank does not view the other fund types, asset holdings or activities where requests for exclusions were made as posing materially less of a systemic risk. Nevertheless, the Central Bank is introducing a different methodological approach to development assets, as outlined in the Policy Document, which takes account of the fact that borrowing is done on a loan-to-cost (LTC) basis for development activity.

3.2 Measure of leverage

As part of the annual Article 25 assessment of funds, the use of leverage by property funds would be determined based on their regularly reported asset and liability values. While the communicated leverage limit is based on total debt-to-total asset values, in practice, it is expected that this would most commonly be applied as an 'adjusted gross leverage' limit.

Feedback

A number of respondents suggested that the use of a rolling leverage limit could introduce risk, due to the pro-cyclical nature of market valuations which could act to tighten or loosen the limit. It was suggested that the limit should apply only to loans at origination, or that the 'long-term property value' be used as a baseline.

Some respondents advocated for the exclusion of shareholder loans.

Questions were raised as to whether references to 'indirect' referred to leverage held by the fund indirectly, and whether the leverage would be calculated on a combined basis.

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Central Bank Response:

The Irish transposition of the AIFMD, together with the ESMA guidelines, provide the basis for the application of the leverage limit. Under ESMA guidelines, the calculation of leverage must be based on one of the four prescribed definitions of leverage as set out in the AIFMD, all of which relate to current leverage (rather than leverage at loan origination), and all of which are calculated using market-based valuations.

The inclusion of shareholder loans in the calculation of a fund's total debt is consistent with the Central Bank's expectations regarding these types of loans from an investor protection perspective. The Central Bank recognises that – from a financial stability perspective – other third-party debt poses greater risks than shareholder debt. However, including shareholder debt in the definition of the leverage metric is consistent with the Central Banks' broader regulatory stance from an investor protection perspective. As outlined in in the AIFMD Central Bank's Alternative Investment Fund Managers' Directive (AIFMD) Q&A , QA 1141 and 1142.ID. The Central Bank does not consider raising capital from investors by way of a shareholder loans to be in principle consistent with the objective of collective investment on behalf of investors. 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.

3.3 Use of a single leverage limit

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 macroprudential objectives of the measures – the Central Bank proposed to apply a single limit across the sector.

Feedback

Some respondents viewed the one-size-fits-all approach as being too blunt. The following alternatives were suggested:

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- The limit should reflect the ease of funding the project (e.g. prime, non-prime).
- Higher levels of leverage be allowed for higher-risk projects (e.g. development), to ensure viability.
- The limit be tailored to reflect the risk assessment for the underlying property (e.g. default risk).
- The limit be on a sliding-scale based on income and financing.
- The limit should reflect lender appetite for the specific asset.
- Higher limits should be given to projects of socioeconomic importance: e.g. social housing and decarbonising development.
- Development projects generally should have a separate (higher) limit as they are financed on an LTC rather than an LTV limit. Alternatively, development project valuations could be based on final development value.
- The limit should vary with the business model of the fund. For example, the limit should not apply to closed-ended funds, or funds with binding capital commitments, or open-ended funds with limited liquidity and less-than-annual redemption cycles.

Some responses indicated that a single limit would have the effect of dis-incentivising investment in some types of real estate, leading to a smaller, more narrowly-focussed industry. However, other responses noted that altering the limit by property type would be too complicated for important mixed-use developments.

Central Bank Response:

In general, the Central Bank views a single limit for different business models as being the most appropriate approach to address the potential systemic risk. The goal of the policy is not to address fund-specific risks, but rather the impacts of the collective behaviour of a cohort of funds (property funds), including actions that may be perfectly rational at an individual-level.

As such, higher limits that are adjusted for the specific risk characteristics of individual funds or sub-sectors would run contrary to the overall goal of this proposed measure, which is about the potential incentives and dynamics generated by funds

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being leveraged in a sector that experiences pro-cyclical valuation shocks. The goal of the measures is not to replace the risk management approach and/or capabilities of individual funds.

Further, on development activity specifically, as lending for development purposes is often done on a loan-to-cost (LTC) basis, the Central Bank has introduced a different methodological approach to development assets, as outlined in the Policy Document.

3.4 Level of the leverage limit

The Central Bank consulted on a fifty per cent leverage limit.

Feedback

One response agreed with the calibration. The remaining responses that address the limit stated that the limit should be higher, on the grounds that:

- fifty per cent is below the level of leverage funds state that they can obtain on the private market. Depending on the response, it was stated that the market currently offers up to 65 per cent, 75 per cent or even eighty per cent leverage.
- fifty per cent was seen as too low for repositioning, repurposing, decarbonisation and housing construction to be viable.
- fifty per cent for property funds was viewed as disproportionate given that seventy-ninety per cent is allowed for households (under the Central Bank's Mortgage Measures).
- Some respondents argued that alternative debt providers would not be willing to provide financing at fifty per cent LTVs as their profit margin would be too low.
- Leverage at the start of the property fund cycle is much higher than at the developed stage, due to pay-down of loans. The limits are therefore most likely to be binding on recently purchased assets.

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- Some respondents argued that the limit was disproportionate given the small amount of funding provided by Irish retail banks currently.
- One respondent indicated that the imposition of the limit would render existing covenants ineffective as they are higher than the limit, which could reduce lenders' control.

Respondents also challenged the Central Bank's basis for a fifty per cent limit on the following grounds:

- It was noted that real estate investment trusts (REITs) are very different and that their leverage limits are justified on investor protection grounds.
- It was argued that in other jurisdictions, allowable leverage levels are higher. Target senior debt levels in the UK were cited at around 57-58 per cent. It was argued that, in Luxembourg, only one per cent of funds used a structure with a fifty per cent limit. It was noted that Germany has recently increased its limit from fifty per cent to sixty per cent.
- It was argued that other jurisdictions, such as Germany, are poor comparisons due to their having more mature markets with lower risk premia. It was also argued that the structure of funds in Europe meant that leverage was often housed below the fund level and therefore not counted.

Many responses argued that a sufficient buffer should be allowed for negative market movements to prevent breaches over the life of the fund. It was noted that the fifty per cent limit would de facto be a forty per cent limit to allow for funds to hold a buffer against regulatory requirements. This was not seen by many respondents as providing enough room for asset price fluctuations. One response proposed a limit of 65 per cent, another proposed a limit of 75 per cent.

Alternatively, some respondents argued that the possible responses to short-term fluctuations in valuations could be dealt with by a different approach to enforcement. In particular, some respondents suggested that even after the transition period, two to three consecutive years of breaches should be allowed before enforcement

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occurs. Other respondents also requested clarity on the approach to enforcement of the limit.

Central Bank Response:

While individual funds and lenders may have a higher individual tolerance for leverage, collectively these decisions can result in poor systemic outcomes.

The Central Bank acknowledges the feedback that property funds will likely seek to maintain leverage at levels below the limit to guard against potential breaches, particularly where these apply to small price movements that may affect only some sub-sectors. To account for that, the Central Bank has calibrated the leverage limit to sixty per cent, relative to the originally proposed fifty per cent.

Individual fund breaches of the leverage limit will be dealt with in accordance with the Central Bank's general approach to failure to adhere to regulatory requirements. As part of this process, the Central Bank's approach to enforcement of the leverage limit will be cognisant of the fact that forced asset sales run contrary to the underlying objective of the limit itself.

3.5 Implementation 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 proposed providing a three-year transition period for those funds.

Feedback

One response agreed that three years was sufficient. Two proposed a period of five years. One respondent noted that the average term of business plans for funds was five to seven years, with leverage paid down over that time, and many funds refinancing mid-term.

Several other respondents claimed that no timeframe would be sufficiently long to comply with the rules, on the grounds that:

- Renegotiations with lenders would not be possible, and/or renegotiation penalties would be incurred.

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- Capital is required to be specified at the beginning of the funds' lifecycle.
- Single investors might not have sufficient capital.
- Three years may not be sufficient to complete some large, committed development projects.
- The limit represents a 'material change' which requires investors be allowed to exit, leading to large withdrawals within 12 months regardless of the stated transition time.

Several respondents indicated that orderly deleveraging would not be possible, as the imposition of the limit would put them in immediate breach of their loan covenants, requiring repayment, due to the potential to be in breach of Central Bank regulation.

As a result of the above, some submissions indicated that they expect sales of some assets in three years, so the proposed Central Bank measures would drive some sales to market now, thereby creating excess assets in the market.

Central Bank Response:

The Central Bank notes respondents' points regarding the limited ability to undertake additional capital raising to reduce their leverage. To the degree that this is the case even in relatively benign periods, this would imply extremely limited options to manage leverage in times of stress. In turn, this raises the likelihood of shocks to the sector leading to forced sales and knock-on effects, and serves to highlight the potential for systemic risk arising from very high levels of leverage in this industry.

The Central Bank recognises that existing property funds will require time to adjust. The Central Bank is therefore providing a five year implementation period for those funds from the date of publication of this document. The implementation period time is longer than initially proposed in order to facilitate a gradual and orderly adjustment to the measures, but also it is reflective of the current macro-economic environment of rising interest rates and a slowdown in global and Irish economic growth since CP145was launched.

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The Central Bank notes that some respondents indicated that the imposition of the leverage limit would put them in immediate breach of their loans covenants. However the Central Bank is providing a five year implementation period for compliance with the leverage limits which should mitigate the potential for any covenant breaches.

See response to Section 2.1 on the issue of a 'material change.'

3.6 Approach to counter-cyclicality

In the event of adverse CRE market shocks, the Central Bank would reserve the right to temporarily remove the limit, subject to conditions. The Central Bank would also retain the option to tighten the limit, as may be required, depending on macro-financial developments.

Feedback

Views on counter-cyclicality were diverse. Some respondents emphasised the need for a stronger counter-cyclical approach, due to fluctuations in underlying market valuations. Other respondents stressed the potential increase in market uncertainty that could arise from a counter-cyclical approach, given the potential need to unwind existing contracts and positions. Particular concern was expressed regarding the effect of uncertainty on development projects.

Requests were made for the Central Bank to clearly outline any procedures and consultations that would occur in the event that the limit was changed, and the likely circumstances under which a change may occur.

Some respondents indicated concern over the Central Bank's ability and willingness to time and execute counter-cyclical interventions appropriately. Several respondents indicated that funds are sufficiently sophisticated market participants to take corrective action in the absence of Central Bank intervention.

Some respondents indicated that current LTV covenants were a more appropriate way of ensuring resilience than counter-cyclical policy. Other respondents proposed increasing the leverage limit so that it would not need to be relaxed except in severe shocks.

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Central Bank Response:

The Central Bank does not intend to recalibrate the leverage limit regularly. These measures are intended to deliver a structural level of resilience for the property fund sector to adverse shocks. Nevertheless, to achieve its macroprudential objective, there will be flexibility to respond to significant changes in the macro-financial environment. The leverage limits will thus be counter-cyclical in nature. The Central Bank recognises the importance of covenants in commercial contracts. However, these are issued on an individual basis to manage individual risk and are not a sufficient tool for managing systemic risk. Further, Central Bank analysis shows that a significant portion of funds' debt will have matured before the leverage limit comes into force, following the five-year implementation period. As such, the Central Bank does not expect that the introduction of the measures will result in funds breaching their loan covenants.

Issues relating to the level of the limit are discussed in Section 3.4.

3.7 Unintended consequences

The main potential economic costs that the Central Bank considered related to the possible impact of the proposed measures on the volume of CRE investment. In addition, as with any intervention, the Central Bank identified the potential for regulatory arbitrage as an unintended consequence of the proposed measures.

Feedback

Most submissions noted that the leverage limits were likely to lower rates of return. Respondents argued that costs may be further increased due to repayment penalties, potentially higher loan penalties, and possible withdrawal of non-bank lenders from the market due to lower levels of total leverage.

Further, respondents were concerned about the increase in uncertainty, due to cumulative regulatory changes, uncertainty arising from counter-cyclical limit changes, and pro-cyclical changes in market value.

Together, respondents indicated that the following unintended consequences may arise:

- Movement to unregulated structures, with resulting loss of transparency to the Central Bank and loss of investor protections.
- Movement of funds to different jurisdictions.
- Short-term forced sale of property by existing vehicles, due to unwillingness of investors to inject more capital for lower returns and/or lenders withdrawal of financing via regulatory covenant breach.
- Reduction of inflows into the Irish economy, as the pool is limited to conservative investors. This may particularly lead to:
    - Reduced delivery of new housing, due to low values during the development phase.
    - Reduced climate retrofitting investment, due to high capital costs.

While these were generally echoes of issues noted in CP145 the view of the respondents was that these effects were likely to be very large. One respondent indicated they would look to move their existing assets to unregulated structures, and would likely not invest more in Ireland through the property fund structure.

Respondents also identified a number of ways in which they believed that the policy may be rendered less effective, including:

- Leverage may be housed at investor rather than fund level.
- Increased potential for fire sales due to pro-cyclical movements in market values.
- Funds may be less willing or able to manage market movements themselves.
- For funds with portfolios concentrated in one or two assets, sell-down to meet the limit may not be possible, and may trigger fire sales. This was of particular concern where funds are closed-ended.

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Central Bank Response:

The Central Bank considers the degree to which high levels of leverage are used to amplify short-term returns to be of some macroprudential concern, particularly where this is predicated on a low interest rate environment and rising asset prices. Collective use of substantial leverage to elevate returns in other markets has been shown to contribute to asset price spirals and can contribute to larger losses in the event of shocks. The Central Bank anticipates that due to their long-term nature, property funds will take a through-the-cycle view of the impact of their leverage choices when making investment decisions.

The Central Bank recognises that more speculative investment may be impacted. Nonetheless, the Central Bank views it as important that excessive risks not be transmitted to the financial system or the broader economy. Funds that meet the leverage limit are less likely to contribute to systemic risk, and the resilience of the overall sector, and Irish economy, will be greater. This, in turn, will better equip the sector to continue to serve as a sustainable source of funding of economic activity.

The Central Bank acknowledges respondents' concern about the increase in uncertainty, due to cumulative regulatory changes and from potential counter-cyclical limit changes. The Central Bank does not expect to change the calibration of the leverage limit regularly. These measures are intended to deliver a structural level of resilience for the property fund sector to adverse shocks. The Central Bank's strategy is to only tighten the limit in the event that evidence of significant market overheating is identified. Further, in the instance of a tightening of the limit, the Central Bank will ensure an appropriate implementation period is allowed- taking account of the prevailing macro-financial environment. The Central Bank will also consider temporarily removing the limit (subject to certain conditions) in the event of a sudden adverse CRE market shock. As such an intervention would likely be in response to rapidly unfolding market events, an implementation period may be counter-productive and hence the temporary removal may be instigated immediately.

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Should risks increase due to use of unregulated structures, the Central Bank may consider additional policy measures with respect to the activities of these structures in the commercial real estate sector. With regards to the relocation or re-domiciling of Irish property investment, the Central Bank will continue to engage fully at the European and international level to influence global policymaking and to identify areas where international cooperation may be needed to prevent policy 'leakages'. The Central Bank recognises the importance of European cooperation in the implementation of measures under Article 25 AIFMD and will actively pursue reciprocity with other NCAs as appropriate.

4. Specific feedback: Guidance on liquidity timeframes

4.1 Coverage of the Guidance

CP145 defines property funds (to which the Guidance applies) as AIFs domiciled in Ireland, authorised under domestic legislation, and investing over fifty per cent directly or indirectly in Irish property assets.

Feedback

Some questions were raised regarding the coverage of the Guidance as follows:

- Some respondents requested that single investor funds be excluded. In particular it was indicated that liquidity timeframes would make property funds less attractive to 'parent' multi-asset funds and daily dealing Life Office funds.
- Respondents generally either requested or assumed that closed-ended funds were excluded from the Guidance.
- One response indicated it may be difficult to prescribe liquidity timeframes to mixed portfolios.

Central Bank Response:

Investment funds are collective investment vehicles which operate on behalf of their members (investors). The exclusion of funds which have a single investor at a point in time, creates both a

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misalignment of policy and is not reflective of the 'collective' nature of funds generally. More broadly, some of the single investors may themselves be financial institutions that act on behalf of multiple investors.

The Central Bank acknowledges that there are some circumstances where the liquidity timeframe would not be required. In particular, and subject to prudent liquidity management by the AIFM, the liquidity timeframe may not be required where (i) the designation of a redemption dealing day is at the discretion of Directors (and not at the option of investors) and (ii) the property fund has sufficient liquid assets not generated by disposal of Irish property assets for the purpose of funding the redemption.

In operational terms, the liquidity timeframe will apply to the whole portfolios of funds who meet the definition of property funds as outlined in CP145 and not just related to the property assets in the portfolio.

4.2 Length of liquidity timeframe

The proposed Guidance stated that 'in general, liquidity timeframes for property funds would be expected to be a minimum of 12 months.' As part of the consultation process, the Central Bank requested that respondents provide additional evidence on the time to sell assets in Ireland if available.

Feedback

No responses provided empirical information on the time to sell assets in Ireland.

Two respondents provided some indication of the time to sell assets, stating:

- times to sell in Ireland are similar to other markets, including the US and UK;
- times to sell are currently estimated between 6 and 12 months;
- there has been an increase in the duration of time to sell certain assets, particularly shopping centres; and

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- most property transactions take 6 months to effect even in a strong market.

No other responses were given.

Central Bank Response:

The Central Bank views the responses as providing broad support for the length of the liquidity timeframes suggested in the original proposal.

The Central Bank will provide an 18 month implementation period for existing funds to take appropriate actions in response to the Guidance. This timeframe is in line with that usually given to funds to meet changes to regulatory requirements.

5. Next steps

Further development of the macroprudential framework for investment funds will remain a key objective of the Central Bank going forward. In keeping with the Central Bank's strategic commitment of strengthening our ability to maintain the resilience of the financial system, it is important to continue to identify potential vulnerabilities and weaknesses in the financial system, including investment funds and other non-banks, and take actions to safeguard resilience. This will ensure the financial system is in a better position to support households and businesses, both in good times and in bad.

A Policy Document which sets out the specific framework design of the macroprudential leverage limits and liquidity timeframes has been published in conjunction with this Feedback Statement. The Central Bank will continue to engage with individual funds and their managers as part of its supervisory engagement to assess firms' progress in implementing the leverage limits and the Guidance on liquidity timeframes.

Appendix 1

Table of submissions received

Type of body	Name of respondent
AIFM	Davy Global Fund Management Limited
	Goodbody Fund Management
	State Street Global Advisors Europe Ltd
Third-party AIF service provider	A&L Goodbody
	Arthur Cox LLP
	Deloitte Ireland
	Dillon Eustace LLP
	McCann FitzGerald LLP
	Northern Trust Fiduciary Services (Ireland) Limited ("NTFSIL")
	Savills Commercial (Ireland) Limited
Industry representative body	CREFC Europe
	Irish Funds
	Irish Fund Directors Association
Property and construction industry	Property Industry Ireland (Ibec)
	John Moran (CEO, JLL Ireland)
Property fund investor	Henderson Park Advisors Ireland
	Urbeo Residential
Financial services firm or group	BCP Asset Management DAC
	Irish Life Group
Other organisation	PwC Ireland

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