Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

# Macroprudential Policy for the Property Fund Sector – Consultation Paper 145

## Feedback from Goodbody Fund Management

**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:
Goodbody supports the Central Bank's objective of safeguarding resilience of the property fund sector to shocks in the Irish commercial real estate "CRE" market. We fully acknowledge that a dislocation in the CRE market in Ireland has the potential to have adverse macroeconomic long-lasting effects.

We note that it is not the regulator's intention for these proposed measures to replace or substitute investors' own risk management procedures. However, we do believe a distinction should be drawn between the ability of retail investors to carry out risk analysis and that of institutional investors. Retail investors, even those who are knowledgeable about property investments, do not typically have the ability to carry out detailed risk analysis and modelling in respect of their decisions to invest in funds. Institutional investors do have such capabilities, access to data and typically deploy very sophisticated risk analysis, cash flow projections and other modelling techniques in their initial and ongoing assessment of investment in CRE funds. In seeking to mitigate financial stability risk, understanding investor behaviour is an important consideration. Sophisticated institutional investors who have carried out detailed risk analysis are less likely to act in a manner that would cause financial instability than are retail investors who have in effect delegated the detailed risk analysis to the fund manager. In this context we do not believe that a limitation on the permitted level of leverage in a CRE fund is merited for institutional investors.

It is additionally our contention that existing regulatory measures are robust, provide appropriate safeguards to investors and have been proven to be effective for property funds in facing market shock. In this respect we reference some aspects of the existing framework namely:

- CRE funds are limited to Qualifying Investors
- Requirements around pre-contractual and ongoing disclosure (including the obligation to set a maximum level of leverage)
- 2020 Central Bank AIFMD Q&A (ID 1141 and 1142) introduced restrictions on the use of shareholder loans as well as recent revenue changes to taxation of shareholder loans
- The Central Bank routinely decline approval of CRE funds >100% leverage
- Available liquidity management tools
- Managers have regulatory obligation to appropriately wind down any failing funds, and
- Lenders are already subject to jurisdictional regulatory oversight and their CRE exposures are significantly less than pre global financial crisis levels

The resilience and functional stability of Irish property funds was demonstrated in how the sector managed through the recent market shock presented by Covid-19 when the market experienced a broad shut down in March 2020 and in the months that followed. This impacted directly on tenants' ability to trade and consequently to pay rent. Trading activity in property assets effectively ceased and occupational demand collapsed. Development programs stalled and completion dates delayed. Valuers incorporated material uncertainty clauses in valuation opinions. Despite these challenges, the property fund sector remained stable. Fund managers closely monitored matters. Investors did not hastily react and seek liquidity, forced asset sales did not materialize, liquidity management tools were not required. Asset management teams managed the assets and engaged proactively with tenants. Most fund loan facilities remained fully compliant, with lenders agreeing covenant waivers to certain borrowers who were most adversely affected. The market stabilised and through 2021 began to recover. There was no evidence that any required ex post measures taken were not effective. As uncertainty waned, institutional investment into the Irish CRE market increased both directly and through Irish property funds.

We would suggest that existing policies are adequate and further policy intervention could lead to market inefficiency and indeed undermine resilience.

Goodbody has significant concerns regarding the proposed measures to impose a 50 per cent leverage limit on property Funds and retrospective application of the proposed leverage limit to existing property Funds (subject to a 3-year transition period). We agree in principle that the alignment of the liquidity timeframe for redemption with the liquidity of underlying assets is an effective way of reducing liquidity mismatch for property funds. We will comment further in our response on the Central Bank's proposed liquidity timeframe of 12 months for property funds established as open-ended QIAIFs with limited liquidity.

**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:
No, we do not agree with the proposed definition noting the differing nature, activity and sectors of the encompassed property funds.

Additionally, the Irish CRE market is considerably broader than the Irish domiciled property fund sector impacted by the proposals. The overall level of leverage and lending practices in the market is critical in maintaining market stability. There are many market participants both international and domestic operating in both regulated and unregulated structures. The Central Bank's macroprudential objectives cannot be achieved in a market by restricting this one element of the market alone. The proposed measures will lessen the appeal to investors of the Irish CRE market. As we outline elsewhere in our response, we believe that if implemented the proposed leverage limits will result in withdrawals and general curtailment of

investment in Irish CRE through regulated Irish property funds. It is in the interests of enhanced stability to increase the level of participation in the market through regulated structures which remain under the supervision of the Central Bank.

**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:
Goodbody currently provides fund management services to property funds with approx. 7.1 bn in Gross AUM as of December 2021. These funds are invested across the wide spectrum of the Irish Commercial Real Estate (CRE) market and include holdings in: hotels, private rented sector, office, logistics, mixed use, shopping centres and development. There is broad diversity across the funds and the investment strategies each seeks to implement. Most funds utilise leverage which is appropriate to the investment strategy and in accordance with the investment objectives of the fund. If implemented, the proposed measures would materially alter the investment objectives and policies of many of these funds, altering the nature of the investment proposition to which investors subscribed.

An analysis of the GFM January 2022 response to the Central Bank questionnaire relating to existing leverage limits in 39 funds shows the following:

***Please refer to PDF attachment at the end of submission to view table***

This analysis indicates that professional investors are investing in funds with leverage in the normal range of 50-65%, with a view to taking on an appropriate level of risk needed to generate their target rate of return. It is important to point out that the leverage in these funds is being measured at one point in time. Some of these funds

were launched over 5 years ago and others were launched more recently. Considering the level of leverage at the point when debt is first drawn down in a fund is highly relevant. This conclusion that leverage of 50-65% is in the normal range is also supported when analysing Loan to Value on drawdown or refinancing of investment loans in our portfolio from 2018 to 2021.

***Please refer to PDF attachment at the end of submission to view table***

An analysis of development loans drawn over the same period show loans ranging from 50% to 100% (fully cross-collateralised) on development cost for speculative commercial development. While this appears high, debt as a percentage of Gross Development Value will be lower.

A single leverage limit applicable to all investment strategies in Irish CRE is not appropriate. The nature of the investment, the sector, the timing of cashflows will all necessitate separate considerations when introducing debt. Lenders must assess the credit risk and will price accordingly. Development schemes, forward funding or forward purchase arrangements, asset management initiatives and stabilised investments all present different risk reward profiles which professional investors seek.

Furthermore, a change in leverage limit will significantly impact the expected return on investment. Goodbody has reviewed cashflow models for the acquisition of a typical'stabilised' investment property in the current market and note that a reduction in leverage from 65% to 50% can result in a reduction in the IRR of over 2.0% per annum; in our sample reducing from 11.9% per annum to 9.8% per annum. If a limit of 50% LTV is introduced, it is in fact likely that funds would adopt a lower LTV on drawdown to provide headroom for market movements. If the LTV on draw down was reduced to 40% to provide this buffer, the IRR in this case would reduce to 8.8% per annum. The magnitude of the impact on the target rate of return for the investor is significant and will warrant a fundamental review of the attractiveness of the opportunity.

The proposed leverage measures will force many existing funds to restructure balance sheets in to comply. This will be costly, in terms of restructuring existing debt arrangements and increased cost of

capital. There could additionally be legal fees and repayment fees up to 1% of the outstanding balance. In addition, the funds may be forced to renegotiate terms in a more difficult interest rate environment. The measures will reduce the return expectations for investors to the point where many projects are deemed unviable e.g. development CRE. Consequently, the proposed measures can be expected to prompt an exodus of capital from the Irish Property Fund sector and indeed from the Irish CRE market.

**Do you agree with the proposed calibration of the 50 per cent total loan to total asset ratio as the appropriate leverage limit for property funds? If not, what level of leverage limit would you see as appropriate for Irish property funds, taking into account the risks the sector is exposed to and the levels of leverage employed by property funds throughout Europe? Please explain why you have suggested this level and the evidence that would support that.**

Response:
We do not agree with the proposed calibration of the 50% total LTV as the appropriate leverage limit for property funds. The Irish CRE market is comprised of a wide range of investors (both domestic and international) with different risk and return appetites. Assets are heterogenous in nature and the various CRE market segments each give rise to different types of risk. Investment strategies and the return expectations of investors are diverse. A blanket limit of 50% on leverage is not appropriate for the range of investors and assets in this market and not competitive with other CRE fund jurisdictions.

As set out in our response to Q3 we have shown that the LTVs on funds managed by GFM are generally between 55% and 75%. We note that in Germany, a jurisdiction specifically referenced in CP145, the Fund Location Act which was passed into law in August 2021 recognised the requirement for more flexibility in this sector with sophisticated investors, whereby it increased the loan-to-value ratio for external financing in Spezialfonds from 50% to 60%. We suggest that the proposal to calibrate the leverage limit for Irish property funds to a total loan to total asset ratio of 50% is heavily simplified and not competitive with European market standards.

We are also of the view that a 50% leverage limit would necessitate actual leverage being materially lower than 50% to ensure that regulatory leverage limits were not breached by even a small reduction in property values. At 45% LTV, a fund would breach its regulatory leverage limits if property values were to fall by 10%.

According to the historical VAR analysis reported by the Central Bank in CP 145,'there is a 99% probability that future price declines in the Irish CRE market would be no more than a 42.6% fall'. Assuming this outcome was realized, all funds holding debt with a LTV of more than 28.7% would breach the regulatory leverage limit.

Assuming a more commercial level of leverage at 60% LTV, the regulatory leverage limit would need to be in the region of 75% to provide sufficient buffer for a 20% market fall. In consideration of these factors, and should a LTV limit in some format still be considered appropriate, it would be more commercial to test any such LTV at inception only.

**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:
Goodbody are of the opinion that retrospective application of the proposed leverage limits should not apply and as such no period of transition is appropriate. It is our view that such measures will induce uncertainty and undermine the Central Bank's objectives. The following factors were considered in forming this opinion:

- The proposal by the Central Bank to introduce a set leverage limit and to make this limit retrospectively applicable to all Irish property funds, would amount to a material change to the investment objectives for all existing and approved funds with leverage limits in excess of the proposed threshold. In each case such a material change to the original investment

proposition, would necessitate notification and thereafter an opportunity for each investor to exit the fund on the same terms as they entered. Given the Irish property fund market is predominately made up of QIAIFs with an annual dealing cycle, the impact of the change would likely be seen some six to twelve months following the introduction of the proposed changes and again just before the expiry of this proposed 3-year period.

- It is possible that a significant number of investors will choose to redeem all or part of their investments following the change in investment objective at the next available dealing date. This concentration of fund disposals, all occurring within a short timeframe, with each Fund seeking to create liquidity to meet investor redemption requests, may lead to the very market conditions that the Bank are seeking to legislate for. A 3-year implementation period would still have potential to amplify adverse shocks and dislocation to commercial real estate and the wider economy.

- An imposition of a 50% leverage limit, even with a period of three years in which to implement the new limit, is likely to cause an immediate breach of lending covenant for those property funds who have entered into a standard covenant not to enter into a transaction which will in the future conflict with a law or regulation applicable to it. Many lending agreements will be put into automatic breach by the possibility of future breach of new regulatory limit on leverage. Lenders may waive such covenants, but any such waivers would have to be negotiated on a case-by-case basis and may come with additional payments, penalties or requirements. Many property funds have no contractual right to request an additional capital injection from the shareholder. Without the ability to inject new equity into the structure, this again increases the risk of forced sales.

- Funds with an income mandate may have to suspend distributions to pay down debt more quickly to get in line with the new limits. This means not delivering on the investment objectives of the fund, not meeting investor expectations, and risking increased redemptions.

- Many property funds would be obliged to refinance existing loans which in turn introduces an additional risk. The required restructuring will increase costs in particular professional fees and refinancing costs and in some cases repayment penalties. The additional costs will not accrue any benefit to investors.
- Identifying and sourcing equity to replace the existing debt will be challenging and it may not be readily available. There is some limited capacity for the conversion of shareholder loans to equity, but we expect this would be an exception as most funds no longer utilise this feature in their financing structures. Without newly introduced equity capital, assets may have to be sold to reduce leverage or facilitate the early wind down of funds. New investors will be less easily enticed into the market. If buyers are not active, the resultant impact may in turn be a decline in CRE values.

Conclusion: Retrospective application is not practical. Average term of CRE business plans is 5-7 years. Leverage naturally unwinds as business plans are implemented, developments complete and asset sales occur in orderly fashion. Many CRE funds also engage in refinancing mid-term. The overall cost/risks of making any proposed measures retrospective far outweighs any perceived benefit.

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

Response:
We do not consider the proposed approach to adjusting the leverage limit in response to price shocks and/or significant overheating to be appropriate. Lenders in this market are sophisticated and experienced when it comes to real estate lending and accordingly the terms of any loan agreement will already contain specific covenants and triggers in respect of the LTV or to measure the performance of the asset more generally. Where there is a market event, or risk of overheating, it is likely that necessary remedies will be taken as

appropriate, and we believe Investors would not favour the uncertainty of movable regulatory goalposts in this regard.

**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:
Yes, we see this as a broadly beneficial intervention to manage potential impact of collective/correlated behaviour arising from liquidity mismatch in the property fund sector.

**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:
Regulation 18 of the Irish AIFM regulations 2013 outlines that funds are already required to align investment strategy, liquidity profile and redemption policy so there shouldn't be fundamental liquidity mismatch in theory. Most of our property Funds are established as closed-ended funds with an ability to extend the term of those funds subject to shareholder approval. For open ended funds with limited liquidity, we agree that formally aligning the timeframe of redemption terms with the liquidity of underlying assets is the most effective way of reducing liquidity mismatch for property funds. 12 months is viewed an appropriate timeframe in this respect.

However, we are fundamentally of the opinion that discretion should be retained by Fund Boards over other non-investor led redemptions e.g. if asset sales complete, it should be feasible to return proceeds to Investors as and when deemed appropriate.

### 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 our experience most property transactions take close to 6 months to effect even at a time when market demand is strong. Currently there is strong demand for property investments particularly in the office and residential sectors. In general properties with smaller lot sizes are more liquid than larger complex assets as there are more potential purchasers. Properties under development may be more illiquid than standard investment properties. Issues may be identified during the sales process which may delay the liquidation of individual assets. We estimate that the liquidity profile of the assets in each of our funds is generally between 181 and 365 days. We have observed increased duration in time to sell Retail property assets and in particular shopping centres of late. We do not have data collated to provide you with complete empirical evidence in this regard.

### 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:
Flight of capital to non-Irish AIFs e.g. UK, Luxembourg, Cayman as Irish CRE funds look to redomicile to jurisdictions with less aggressive leverage constraints. This doesn't change the leverage being deployed to CRE assets but makes Ireland's asset management industry less competitive and lessens the degree of Central Bank visibility and ability for regulatory oversight. While Germany is a significant European location for property funds, it would not be considered a peer/competitor of Ireland from an Investment funds perspective. We therefore don't believe the analysis presented in CP145 would necessarily be indicative of Irish outcome.

We note CP 145 estimates that 1.3bn of new contributions over the next 3 years (considering 5.6bn of net subscriptions to Irish CRE over the past 3 years) should be an achievable target to remedy the leverage corrections necessary. Fundamentally we would suggest

this presumption does not consider and indeed overestimates investors' appetite/ability to continue to deploy capital at the proposed tighter leverage level, which represents a very different IRR proposition. There is a real risk of narrowing the investor pool to just those who seek conservative returns as Investors who seek higher risk/higher IRR (e.g. through Development CRE) could begin to fall away. A reduction in much needed Irish CRE investment on an overall basis could be a very likely unintended consequence of these measures.

- Property funds as investors should not be carved out from other Investors in Irish CRE as to do so is likely to cause a migration of investors from property funds to direct investment, investment through third unregulated structures, or housing leverage at investor level circumventing the spirit of any measures. These alternatives increasing cost, potential tax bill and overall burden for investors and fundamentally resulting in no change to perceived systemic risk from Central Bank perspective i.e., real estate development will still be required and funded. These regulatory arbitrage driven solutions serve as an administrative burden, will cause delays in building projects also lessen visibility of Central Bank to these investments.

- Many Irish CRE legacy buildings will require energy and climate-related retrofit to support decarbonisation of the economy in the coming years. These asset types which require high capital expenditure investment, and an active asset management strategy will likely be among those most impacted by any proposed leverage restrictions as investment opportunity becomes less attractive. This could delay Irish CRE sector responding to the challenges of climate change and ESG, core areas of focus on the Central Bank's agenda.

**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:
The operational difficulties in complying with the leverage limits envisaged by the AIFM are principally covered off in our response to Q5

**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:
No operational difficulties envisaged but additionally, (and as laid out already in our response to Q8/11 we suggest that Fund Boards retain discretion over timing of non-investor led redemptions.

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

## Response:

**CP 145 Macroprudential measures for the property fund sector**

This response is being provided to the Central Bank of Ireland ("Central Bank") from Goodbody Fund Management ("GFM") and Goodbody Stockbrokers Property Team ("GBS"), collectively "Goodbody" for the purposes of this paper.

**Q1 - 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?**

Goodbody supports the Central Bank's objective of safeguarding resilience of the property fund sector to shocks in the Irish commercial real estate "CRE" market. We fully acknowledge that a dislocation in the CRE market in Ireland has the potential to have adverse macroeconomic long-lasting effects.

We note that it is not the regulator's intention for these proposed measures to replace or substitute investors' own risk management procedures. However, we do believe a distinction should be drawn between the ability of retail investors to carry out risk analysis and that of institutional investors. Retail investors, even those who are knowledgeable about property investments, do not typically have the ability to carry out detailed risk analysis and modelling in respect of their decisions to invest in funds. Institutional investors do have such capabilities, access to data and typically deploy very sophisticated risk analysis, cash flow projections and other modelling techniques in their initial and ongoing assessment of investment in CRE funds. In seeking to mitigate financial stability risk, understanding investor behaviour is an important consideration. Sophisticated institutional investors who have carried out detailed risk analysis are less likely to act in a manner that would cause financial instability than are retail investors who have in effect delegated the detailed risk analysis to the fund manager. In this context we do not believe that a limitation on the permitted level of leverage in a CRE fund is merited for institutional investors.

It is additionally our contention that existing regulatory measures are robust, provide appropriate safeguards to investors and have been proven to be effective for property funds in facing market shock. In this respect we reference some aspects of the existing framework namely:

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- Available liquidity management tools
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- Lenders are already subject to jurisdictional regulatory oversight and their CRE exposures are significantly less than pre global financial crisis levels

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waivers to certain borrowers who were most adversely affected. The market stabilised and through 2021 began to recover. There was no evidence that any required ex post measures taken were not effective. As uncertainty waned, institutional investment into the Irish CRE market increased both directly and through Irish property funds.

We would suggest that existing policies are adequate and further policy intervention could lead to market inefficiency and indeed undermine resilience.

Goodbody has significant concerns regarding the proposed measures to impose a 50 per cent leverage limit on property Funds and retrospective application of the proposed leverage limit to existing property Funds (subject to a 3-year transition period). We agree in principle that the alignment of the liquidity timeframe for redemption with the liquidity of underlying assets is an effective way of reducing liquidity mismatch for property funds. We will comment further in our response on the Central Bank's proposed liquidity timeframe of 12 months for property funds established as open-ended QIAIFs with limited liquidity.

**Q2 - 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?**

No, we do not agree with the proposed definition noting the differing nature, activity and sectors of the encompassed property funds.

Additionally, the Irish CRE market is considerably broader than the Irish domiciled property fund sector impacted by the proposals. The overall level of leverage and lending practices in the market is critical in maintaining market stability. There are many market participants both international and domestic operating in both regulated and unregulated structures. The Central Bank's macroprudential objectives cannot be achieved in a market by restricting this one element of the market alone. The proposed measures will lessen the appeal to investors of the Irish CRE market. As we outline elsewhere in our response, we believe that if implemented the proposed leverage limits will result in withdrawals and general curtailment of investment in Irish CRE through regulated Irish property funds. It is in the interests of enhanced stability to increase the level of participation in the market through regulated structures which remain under the supervision of the Central Bank.

**Q3 - 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)?**

Goodbody currently provides fund management services to property funds with approx. €7.1 bn in Gross AUM as of December 2021. These funds are invested across the wide spectrum of the Irish Commercial Real Estate (CRE) market and include holdings in: hotels, private rented sector, office, logistics, mixed use, shopping centres and development. There is broad diversity across the funds and the investment strategies each seeks to implement. Most funds utilise leverage which is appropriate to the investment strategy and in accordance with the investment objectives of the fund. If implemented, the proposed measures would materially alter the investment objectives and policies of many of these funds, altering the nature of the investment proposition to which investors subscribed.

9.8% per annum. If a limit of 50% LTV is introduced, it is in fact likely that funds would adopt a lower LTV on drawdown to provide headroom for market movements. If the LTV on draw down was reduced to 40% to provide this buffer, the IRR in this case would reduce to 8.8% per annum. The magnitude of the impact on the target rate of return for the investor is significant and will warrant a fundamental review of the attractiveness of the opportunity.

The proposed leverage measures will force many existing funds to restructure balance sheets in to comply. This will be costly, in terms of restructuring existing debt arrangements and increased cost of capital. There could additionally be legal fees and repayment fees up to 1% of the outstanding balance. In addition, the funds may be forced to renegotiate terms in a more difficult interest rate environment. The measures will reduce the return expectations for investors to the point where many projects are deemed unviable e.g. development CRE. Consequently, the proposed measures can be expected to prompt an exodus of capital from the Irish Property Fund sector and indeed from the Irish CRE market.

**Q4 - 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.**

We do not agree with the proposed calibration of the 50% total LTV as the appropriate leverage limit for property funds. The Irish CRE market is comprised of a wide range of investors (both domestic and international) with different risk and return appetites. Assets are heterogenous in nature and the various CRE market segments each give rise to different types of risk. Investment strategies and the return expectations of investors are diverse. A blanket limit of 50% on leverage is not appropriate for the range of investors and assets in this market and not competitive with other CRE fund jurisdictions.

As set out in our response to Q3 we have shown that the LTVs on funds managed by GFM are generally between 55% and 75%. We note that in Germany, a jurisdiction specifically referenced in CP145, the Fund Location Act which was passed into law in August 2021 recognised the requirement for more flexibility in this sector with sophisticated investors, whereby it increased the loan-to-value ratio for external financing in Spezialfonds from 50% to 60%. We suggest that the proposal to calibrate the leverage limit for Irish property funds to a total loan to total asset ratio of 50% is heavily simplified and not competitive with European market standards.

We are also of the view that a 50% leverage limit would necessitate actual leverage being materially lower than 50% to ensure that regulatory leverage limits were not breached by even a small reduction in property values. At 45% LTV, a fund would breach its regulatory leverage limits if property values were to fall by 10%.

According to the historical VAR analysis reported by the Central Bank in CP 145, 'there is a 99% probability that future price declines in the Irish CRE market would be no more than a 42.6% fall'. Assuming this outcome was realized, all funds holding debt with a LTV of more than 28.7% would breach the regulatory leverage limit.

Assuming a more commercial level of leverage at 60% LTV, the regulatory leverage limit would need to be in the region of 75% to provide sufficient buffer for a 20% market fall. In consideration of these factors, and should a LTV limit in some format still be considered appropriate, it would be more commercial to test any such LTV at inception only.

**Q5 - 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 analysis of the GFM January 2022 response to the Central Bank questionnaire relating to existing leverage limits in 39 funds shows the following:

**Central Bank Annual Property Funds Questionnaire GFM Analysis of LTV:**

| No. of CRE Funds reported by GFM at 31 Dec 2021 | % | LTVs Range | Comment |
|---|---|---|---|
| 4 | 10% | 70-78% | 3 of these leveraged funds have significant holdings in retail which have been impacted by considerable declines in the value of retail properties over the past 3 years |
| 21 | 54% | 50-65% | Leverage in the normal range |
| 6 | 15% | <50% | 2 funds are engaged in development and leverage reported is on a loan to cost ratio, leverage will likely increase on completion. 2 further funds have invested indirectly through other vehicles which hold debt in the normal range of 50% to 65%. 1 fund holds multiple assets not all of which are leveraged. |
| 8 | 21% | No Leverage | 6 of these funds have invested indirectly through other vehicles which hold debt in the normal range of 50% to 65%, 2 are funds holding sites for future development which envisage drawdown of debt in the future in the normal range of up to 65% debt and 2 funds have completed assets sales and are being wound down. |
| **39** | **100%** | | |

This analysis indicates that professional investors are investing in funds with leverage in the normal range of 50-65%, with a view to taking on an appropriate level of risk needed to generate their target rate of return. It is important to point out that the leverage in these funds is being measured at one point in time. Some of these funds were launched over 5 years ago and others were launched more recently. Considering the level of leverage at the point when debt is first drawn down in a fund is highly relevant. This conclusion that leverage of 50-65% is in the normal range is also supported when analysing Loan to Value on drawdown or refinancing of investment loans in our portfolio from 2018 to 2021.

**Loan to Value on drawdown or refinancing of investment loans > €2.5bn from 2018 to 2021:**

| No. of Investment loans >€2.5bn refinanced from 2018 to 2021 | % | LTVs Range | Comment |
|---|---|---|---|
| 3 | 14% | 50-54% | These loans have been provided by a mixture of Irish (9 loans) and non-Irish (13 loans) lenders, with no discernable difference in the approach to LTV from the 3 Irish lenders and the 6 non-Irish lenders |
| 2 | 9% | 55-59% | |
| 12 | 55% | 60-64% | |
| 3 | 14% | 65-69% | |
| 2 | 9% | 70-75% | |
| **22** | **100%** | | |

An analysis of development loans drawn over the same period show loans ranging from 50% to 100% (fully cross-collateralised) on development cost for speculative commercial development. While this appears high, debt as a percentage of Gross Development Value will be lower.

A single leverage limit applicable to all investment strategies in Irish CRE is not appropriate. The nature of the investment, the sector, the timing of cashflows will all necessitate separate considerations when introducing debt. Lenders must assess the credit risk and will price accordingly. Development schemes, forward funding or forward purchase arrangements, asset management initiatives and stabilised investments all present different risk reward profiles which professional investors seek.

Furthermore, a change in leverage limit will significantly impact the expected return on investment. Goodbody has reviewed cashflow models for the acquisition of a typical 'stabilised' investment property in the current market and note that a reduction in leverage from 65% to 50% can result in a reduction in the IRR of over 2.0% per annum; in our sample reducing from 11.9% per annum to

**an alternative transition timeframe be? Please explain why you have suggested this alternative length of time.**

Goodbody are of the opinion that retrospective application of the proposed leverage limits should not apply and as such no period of transition is appropriate. It is our view that such measures will induce uncertainty and undermine the Central Bank's objectives. The following factors were considered in forming this opinion:

- The proposal by the Central Bank to introduce a set leverage limit and to make this limit retrospectively applicable to all Irish property funds, would amount to a **material change to the investment objectives** for all existing and approved funds with leverage limits in excess of the proposed threshold. In each case such a material change to the original investment proposition, would necessitate notification and thereafter an opportunity for each investor to exit the fund on the same terms as they entered. Given the Irish property fund market is predominately made up of QIAIFs with an annual dealing cycle, the impact of the change would likely be seen some six to twelve months following the introduction of the proposed changes and again just before the expiry of this proposed 3-year period.
- It is possible that a significant number of investors will choose to redeem all or part of their investments following the change in investment objective at the next available dealing date. This concentration of fund disposals, all occurring within a short timeframe, with each Fund seeking to create liquidity to meet investor redemption requests, may lead to the very market conditions that the Bank are seeking to legislate for. A 3-year implementation period would still have potential **to amplify adverse shocks and dislocation** to commercial real estate and the wider economy.
- An imposition of a 50% leverage limit, even with a period of three years in which to implement the new limit, is likely to cause an immediate **breach of lending covenant** for those property funds who have entered into a standard covenant not to enter into a transaction which will in the future conflict with a law or regulation applicable to it. Many lending agreements will be put into automatic breach by the possibility of future breach of new regulatory limit on leverage. Lenders may waive such covenants, but any such waivers would have to be negotiated on a case-by-case basis and may come with additional payments, penalties or requirements. Many property funds have no contractual right to request an additional capital injection from the shareholder. Without the ability to inject new equity into the structure, this again increases the risk of forced sales.
- **Funds with an income mandate may have to suspend distributions** to pay down debt more quickly to get in line with the new limits. This means not delivering on the investment objectives of the fund, not meeting investor expectations, and risking increased redemptions.
- Many property funds would be obliged to **refinance existing loans which in turn introduces an additional risk.** The required restructuring will increase costs in particular professional fees and refinancing costs and in some cases repayment penalties. The additional costs will not accrue any benefit to investors.
- **Identifying and sourcing equity to replace the existing debt will be challenging** and it may not be readily available. There is some limited capacity for the conversion of shareholder loans to equity, but we expect this would be an exception as most funds no longer utilise this feature in their financing structures. Without newly introduced equity capital, assets may have to be sold to reduce leverage or facilitate the early wind down of funds. New investors will be less easily enticed into the market. If buyers are not active, the resultant impact may in turn be a decline in CRE values.

  Conclusion: Retrospective application is not practical. Average term of CRE business plans is 5-7 years. Leverage naturally unwinds as business plans are implemented, developments complete and asset sales occur in orderly fashion. Many CRE funds also engage in refinancing mid-term. The overall cost/risks of making any proposed measures retrospective far outweighs any perceived benefit.

**Q6 - 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?**

We do not consider the proposed approach to adjusting the leverage limit in response to price shocks and/or significant overheating to be appropriate. Lenders in this market are sophisticated and experienced when it comes to real estate lending and accordingly the terms of any loan agreement will already contain specific covenants and triggers in respect of the LTV or to measure the performance of the asset more generally. Where there is a market event, or risk of overheating, it is likely that necessary remedies will be taken as appropriate, and we believe Investors would not favour the uncertainty of movable regulatory goalposts in this regard.

**Q7 - 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?**

Yes, we see this as a broadly beneficial intervention to manage potential impact of collective/correlated behaviour arising from liquidity mismatch in the property fund sector.

**Q8 - 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?**

Regulation 18 of the Irish AIFM regulations 2013 outlines that funds are already required to align investment strategy, liquidity profile and redemption policy so there shouldn't be fundamental liquidity mismatch in theory. Most of our property Funds are established as closed-ended funds with an ability to extend the term of those funds subject to shareholder approval. For open ended funds with limited liquidity, we agree that formally aligning the timeframe of redemption terms with the liquidity of underlying assets is the most effective way of reducing liquidity mismatch for property funds. 12 months is viewed an appropriate timeframe in this respect.

However, we are fundamentally of the opinion that discretion should be retained by Fund Boards over other non-investor led redemptions e.g. if asset sales complete, it should be feasible to return proceeds to Investors as and when deemed appropriate.

**Q9 - 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? Please either use the box below to respond, or attach relevant files. If attaching evidence, please provide it in PDF, Word- or Excel-readable formats. For data evidence, Excel-readable format is preferred.**

In our experience most property transactions take close to 6 months to effect even at a time when market demand is strong. Currently there is strong demand for property investments particularly in the office and residential sectors. In general properties with smaller lot sizes are more liquid than larger complex assets as there are more potential purchasers. Properties under development may be more illiquid than standard investment properties. Issues may be identified during the sales process which may delay the liquidation of individual assets. We estimate that the liquidity profile of the assets in each of our funds is generally between 181 and 365 days. We have observed increased duration in time to sell Retail property assets and in particular shopping centres of late. We do not have data collated to provide you with complete empirical evidence in this regard.

**Q10 - 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?**

- Flight of capital to non-Irish AIFs e.g. UK, Luxembourg, Cayman as **Irish CRE funds look to redomicile** to jurisdictions with less aggressive leverage constraints. This doesn't change the leverage being deployed to CRE assets but makes Ireland's asset management industry less competitive and lessens the degree of Central Bank visibility and ability for regulatory oversight. While Germany is a significant European location for property funds, it would not be considered a peer/competitor of Ireland from an Investment funds perspective. We therefore don't believe the analysis presented in CP145 would necessarily be indicative of Irish outcome.
- We note CP 145 estimates that €1.3bn of new contributions over the next 3 years (considering €5.6bn of net subscriptions to Irish CRE over the past 3 years) should be an achievable target to remedy the leverage corrections necessary. Fundamentally we would suggest this presumption does not consider and indeed overestimates investors' appetite/ability to continue to deploy capital at the proposed tighter leverage level, which represents a very different IRR proposition. There is a real risk of narrowing the investor pool to just those who seek conservative returns as Investors who seek higher risk/higher IRR (e.g. through Development CRE) could begin to fall away. **A reduction in much needed Irish CRE investment** on an overall basis could be a very likely unintended consequence of these measures.
- Property funds as investors should not be carved out from other Investors in Irish CRE as to do so is likely to cause a migration of investors from property funds to direct investment, investment through third unregulated structures, or housing leverage at investor level circumventing the spirit of any measures. These alternatives increasing cost, potential tax bill and overall burden for investors and fundamentally resulting in no change to perceived systemic risk from Central Bank perspective i.e., real estate development will still be required and funded. These **regulatory arbitrage** driven solutions serve as an administrative burden, will cause delays in building projects also lessen visibility of Central Bank to these investments.
- Many Irish CRE legacy buildings will require energy and climate-related retrofit to support decarbonisation of the economy in the coming years. These asset types which require high capital expenditure investment, and an active asset management strategy will likely be among those most impacted by any proposed leverage restrictions as investment opportunity becomes less attractive. This could **delay Irish CRE sector responding to the challenges of climate change and ESG**, core areas of focus on the Central Bank's agenda.

**Q11 - If you have any further thoughts or considerations on the proposals outlined in Consultation Paper 145, please share them below.**

In summary and reflective of the views of our clients who are substantial participants in the Irish Real Estate Market, we are proposing:

- Retrospective application of any proposed measure is not appropriate
- If a leverage limit were to be imposed, it should be set at a level in line with current commercial lending practices and any leverage limit should only be tested at inception of the loan, not periodically, otherwise buffers would need to be incorporated into same
- The Central Bank should not set a single leverage limit across the quite diverse range of property funds investing in Ireland, construction and development loans specifically have very different risk/return and financing horizon considerations
- We are supportive of formalising the liquidity timeframe proposals for open ended property funds but note that Fund board discretion should be retained to facilitate non-investor led redemptions

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