Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Macroprudential Policy for the Property Fund Sector – Consultation Paper 145

Feedback from John Moran

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:
We raise no issues with the proposed liquidity mismatches by the Central Bank.

However, we do not agree with the proposals concerning leverage limits of property funds. Such a move has the potential to impact the future supply of housing in the state, at a time when supply is at chronically low levels.

The CBI's stated policy objective is "to safeguard the resilience of Irish property funds so that the sector is better able to absorb, rather than amplify, adverse shocks in future times of stress". The CBI identifies the "main risk that [its] proposed interventions seek to guard against" as "the potential for forced selling behaviour by the property fund sector as a whole". We fully and unequivocally support that objective and that concern.

In our opinion, the leverage limit as proposed would not achieve the CBI's policy aims.

Briefly described, these are our main concerns, most of which are discussed in a little more detail elsewhere in these submissions.

(1) Pre-existing funds and loans should be grandfathered and entirely excluded from the proposed leverage limit.

We believe that the most important source of resilience in the post-GFC Irish real estate market is the diverse participation of international and institutional capital, both equity and debt. Several aspects of the proposed measure would be interpreted by markets as retrospective regulation – a perception of political risk that could damage Ireland's competitiveness and attractiveness as an investment market and driving away precisely the kind of capital that has given it stability and resilience in recent years. Those aspects are:

(a) setting the limit at just 50% when the normal senior lending LTV range (in Ireland as in other comparable markets) is in the 55%-65% range;

(b) the inclusion of shareholder debt (a questionable policy option, and one that affects only pre-existing funds – see further (2) below); and

(c) a transition period of just three years, when affected funds would typically hold assets for significantly longer than that after fully drawing down their investors' equity commitments

(2) Data tools to help all market participants better understand and manage property cycle risk would be more effective, and avoid the arbitrage risk implicit in the current proposal.

(3) If it is to increase, and not reduce, market resilience, any leverage limit should apply once, at the point of loan inception, and not throughout the life of the loan.

(4) Shareholder debt is economically equity and irrelevant to market resilience; it should not be included in the leverage limit.

Shareholder debt does not have the characteristics of debt that are relevant to market resilience. Equity investors used it to inject capital into structures because of commercial flexibility (easier profit extraction) and (historically) tax efficiency. As CP145 notes, the use of shareholder debt is no longer allowed for the funds targeted by these measures – but there are existing funds that have been capitalised in this way. These funds (simply by virtue of having been set up before the ban on the use of shareholder debt came into effect) are likely to have already drawn down committed capital. If shareholder debt is included in the leverage limit and such funds breach it either immediately or because of market movements during their life, they are unlikely to have access to additional equity, so will only be able to stay within the leverage limit by selling assets.

An alternative solution would be to fully grandfather pre-existing funds from the proposed leverage limit (given that new funds do not use shareholder debt), as suggested at (1) above.

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 disagree with the proposed targeting of the leverage limit at "property funds" as defined.

Firstly, we are concerned at the arbitrage risk created by the proposed reliance on this definition to set the scope of the leverage limit. Imposing leverage limits on AIFs captures only part of the property investment market, creating arbitrage risk, as discussed in our response to the previous question. The CBI does not adequately explain why targeting this (most institutional and international) part of the market makes. CP145 notes that the alternative of limiting leverage by targeting lenders would (also) be problematic, because the CBI lacks the power to control lending by many of the lender types in the market.

We see two possible consequences of the use of this "property funds"definition to set the scope of the proposed leverage limit:

(1) At the highest level, the CBI's proposed approach may encourage international investors (and lenders), for many of whom the use of the AIFMD is attractive, to reduce their participation in the Irish real estate market altogether – that would not benefit a market whose resilience has been strengthened in recent years by the increased participation of international institutional capital.

(2) Within the context of the Irish real estate market, the CBI's proposed approach may encourage investors and lenders to stop using the AIFMD framework and use different vehicles and structures, beyond the application of the proposed leverage limit. So even to the extent that the amount of capital in the market were unchanged, the balance would shift from the more transparent and regulated part of the market to the less transparent, less regulated part of the market.

It should be noted that in comparing leverage levels between Irish and European/international funds, it is important to be aware of market differences that may mean like is not being compared with like. In particular, it is a feature of the Irish AIF market that many ICAV AIFs are in fact individual asset-holding vehicles that are wholly owned by an (ultimately diversely owned) investment fund vehicle. Both investors and lenders tend to prefer property-backed secured debt to sit in the asset-asset-holding vehicle, and not at the level of the fund vehicle – so one would expect to see higher leverage in such AIFs, and (given the structure of the Irish market) in Irish AIFs generally, as compared to AIFs in markets where the AIF is much more commonly the parent investment fund vehicle which owns individual asset-holding (and individually leveraged) vehicles.

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:
If a regulatory LTV cap is to be imposed, we would urge that it is based on a sliding scale rather than a single leverage limit.

One area where a differently calibrated leverage limit may be appropriate is construction and major refurbishment projects. In those contexts, debt is used to fund expenditure that seeks to enhance the value of the relevant asset, rather than simply to help fund an acquisition or refinancing on a basis that can be economically paid for through rental income. At the same time, construction finance and transitional assets are generally (and rightly) regarded as higher risk, and often require higher levels of leverage to achieve viability. This category of real estate financings is especially important because it is likely that many building renovations over the coming years will need to incorporate energy and climate-related retrofit to support decarbonisation of the economy (and preserve the value of assets that may otherwise become obsolete). It would be a bad outcome for Ireland if regulatory leverage limits impeded the funding of such capital expenditure.

itself retrospectively prevented from executing its investment strategy.

Both in the interests of preventing shocks to existing funds (and their international and institutional investors) and to protect the interests of existing lenders (banks and non-banks, domestic and international), we would strongly recommend simply excluding existing funds and loans already in place from the scope of the proposed measure.

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:
No, we believe that any leverage limit should be calibrated in such a way as to be unlikely to be tripped other than by outlier cases.

A regulatory leverage limit set by reference to market value-based LTV that is tested periodically strikes us as inherently destabilising. It is a blunt instrument, compliance with which would be very difficult for market participants to ensure. It would reduce the scope for efficient use of equity and debt capital, render more transactions and projects economically unviable, and undermine the responsibility that lenders are accustomed to exercising through credit underwriting, financial covenants and commercial judgment.

It is an inherent feature of such a measure that "large, unanticipated adverse price shocks and/or significant overheating" may trigger widespread breaches, and (in the closed-ended property funds world where it makes no sense to maintain significant equity buffers) forced sales. Rather than introduce a measure that inevitably entails that risk, and thus the need for a regulatory power to counter it, it would be better to manage the risk of excessive leverage differently.

The fact that a lender has the ex-post power to use an LTV covenant breach to renegotiate terms (and may choose to grant a waiver even if the borrower cannot inject additional equity to cure the breach) is

in our view more resilience-enhancing than an ex-ante regulatory leverage limit that could be triggered simply because of market movements (putting the CBI in the uncomfortable position of needing to decide whether to exercise its power to adjust the level of the leverage limit to avoid widespread forced sales).

Presumably, market participants would in such circumstances look to the CBI to exercise that power, further undermining the rationale behind the measure.

Do you agree with the use of Guidance on liquidity timeframes (with a focus on longer notification periods) to reduce liquidity mismatch in property funds? If not, how would you propose to reduce liquidity mismatch in property funds?

Response:

Do you agree that 12 months is an appropriate liquidity timeframe (notification period plus settlement period) for property funds, to ensure that a sufficient timeframe is available to meet unexpected redemptions without requiring forced sales, even under conditions of collective market stress? If not, how long of a liquidity timeframe period do you think would be sufficient to reduce liquidity mismatch, even under conditions of collective market stress?

Response:

Do you have any additional evidence on the time it takes to sell property assets in Ireland, both in normal market conditions and in times of stress?

Response:

In addition to the analysis provided in Consultation Paper 145, what potential unintended consequences do you see from the proposed measures, and how could these be mitigated?

Response:
In common with our submissions generally, these comments relate to the leverage proposals only.

As explained in our other responses, we are concerned that the imposition on the more regulated part of the Irish property market of a simple, market value-based leverage limit that is tested periodically, without grandfathering existing funds and loans, would:

- Reduce the participation of international and institutional capital in the Irish property market (in turn reducing the resilience of that market), and/or
- Drive capital to invest less through the AIFMD regulatory framework and more through vehicles and structures not subject to the leverage limit,
- Increase the likelihood that large, unanticipated adverse price shocks and/or significant overheating would trigger widespread forced sales (or that the CBI would have to adjust the leverage limit to avoid them), and
- Undermine the ability of, and incentives for, market participants to manage property cycle risk and leverage responsibly themselves.

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:
[Already discussed]

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:
[Already discussed]

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

Response:

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

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