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Macroprudential Policy for the Property Fund Sector – Consultation Paper 145

Feedback from PwC Ireland

Do you agree with the proposal in Consultation Paper 145 to limit leverage and introduce additional Guidance around liquidity mismatches as a means to meet the Central Bank's objective of safeguarding resilience of the property fund sector to shocks in the Irish CRE market? If not, which measures, or combination of measures, do you think best meet the objective of safeguarding resilience of the property funds sector, so that it is better able to absorb – rather than amplify – shocks in the Irish CRE market?

Response:
PwC recognises the importance of measures to safeguard the resilience and financial stability of the Irish commercial real estate (CRE) market, so that it is better able to absorb – rather than amplify – future adverse shocks so that the sector is better equipped to continue to serve its purpose as a valuable and sustainable source of funding for economic activity.

By way of further explanation, Irish property funds have become a key participant in the Irish commercial real estate market in recent years. This entails benefits for both macroeconomic and financial stability, through increased diversification of funding sources . According to the Central Bank of Ireland's Financial Stability Review 2021, alternative investment funds (AIFs) domiciled and regulated in Ireland with significant holdings of Irish property assets (henceforth referred to as'property funds'), had holdings of Irish property assets valued at 23 billion (or 43%), out of the 53 billion estimated total value of Irish invested CRE assets. The macroprudential measures which the CBI are proposing to introduce will therefore only address the portion of the CRE market which is held through Irish regulated AIFs.

We are therefore concerned that the proposed measure in relation to the imposition of a leverage limit of 50% on the impacted Central Bank of Ireland (CBI) regulated AIFs will lead to a change in the nature of the structures through which Irish property assets are held to less regulated or unregulated structure in Ireland or in other jurisdictions and not to a reduction in the level of leverage through which such assets are funded. As such the policy objective of the CBI to improve the resilience of the financing of the Irish commercial real estate (CRE) market may not be achieved.

To illustrate this point we refer to the chart on Legal regime and structure included on page 12 of the 2021 Luxembourg Real Estate Investment Funds Survey (Source: https://www.alfi.lu/en-gb/pages/setting-up-in-luxembourg/alternative-investment-funds-asset-classes/real-estate) from the Luxembourg Funds Industry Association (ALFI) which shows the evolution of the assets under management (AUM) in Luxembourg real estate structures from 2019 to 2021. In Luxembourg, Part II funds are regulated AIFs which are subject to the IML/CSSF circular 91/75 and have a 50% maximum leverage ratio. The less regulated SIF/SICAR fund structures and the unregulated RAIF structures do not have any leverage limits for real estate funds. Between 2019 and 2021 the market share of unregulated structures in Luxembourg (RAIF and Not regulated) has expanded from 25% of the market in 2019 to a 40% share of the market in 2021. In 2021, the Part II UCIs now only account for about 1% of the Luxembourg real estate funds market.

A related issue which may arise with the use of alternative financing structures such as unregulated special purpose vehicles (SPVs) or AIFs domiciled in another jurisdiction is the loss of market transparency which the CBI currently enjoys through the reporting it receives under Regulation 25 of the European Union (Alternative Investment Fund Managers) Regulations, 2013 (AIFMD Regulations) [S.I. No. 257 of 2013] for Irish domiciled AIFs. The loss of such reporting could curtail or inhibit the ability of the CBI to monitor the level of financial stability risk in the Irish market.

PwC welcomes the recently published CBI Market-Based Finance Monitor which aims to monitor activities and balance sheet trends in the Irish market-based finance sector that could point to potential financial vulnerabilities.

We also think that there is merit in the CBI collating and publishing data which more fully addresses the macroprudential risk and financial stability concerns which the CBI has identified with the Irish property funds sector. The additional data to be published should include:

Details on the sectors within the real estate sector (office, retail, residential, land development, industrial and other) in which Irish property funds have invested over at least the last 3 year period;

- Details of the sources of funding (Equity, shareholder debt, connected party debt, bank debt, debt from other sources) employed by Irish property funds over at least the last 3 year period;
- Details of the third party Loan to Value Ratios (LTVs) of Irish property funds over at least the last 3 year period by real estate sector;
- Details of the split of Irish property funds between Closed-Ended Funds, Funds with Limited Liquidity and Open-Ended Funds over at least the last 3 year period;
- Details of the current distribution of property funds between single investors funds and multi-investor funds and the trend over the previous 3 years;
- Details of the third party LTVs between single investors funds and multi-investor funds and the trend over the previous 3 years; and
- Details of the current dealing frequencies versus liquidity timeframes employed by Irish property funds and the trend over the previous 3 years.

The CBI should also look to gather data on the Debt Yields in the Irish real estate sector. The Debt Yield which is defined as the net income dividend by the loan advance provides an alternative measure to the LTV ratio. It stands as an income-based measure that can be used to ensure that a loan amount is not inflated due to low market cap rates, low interest rates or high amortization periods and is a common metric used to compare risk relative to other loans.

The provision of sufficient transparent information about both the current position of the Irish property funds sector and information on the movements or trends over the preceding 3 year period will enable all stakeholders to have a better understanding of the leverage and liquidity risks present in the market and the trajectory of those risks.

In order for all stakeholders to better understand and to be able to assess the level and nature of the financial stability risk in the Irish real estate market the CBI should also look to obtain and publish

similar data (to the above) on the approximately 60% of the Irish invested real estate assets not owned by Irish property funds.

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:
Through the proposed introduction of the macroprudential measures the CBI is aiming to strengthen the resilience of the Irish real estate market, and guard against the risk that financial vulnerabilities in the sector amplify adverse shocks in future times of stress.

However, according to the CBI's Financial Stability Review 2021, Irish domiciled alternative investment funds (AIFs) with significant holdings of Irish property assets (henceforth referred to as'property funds'), only represented 43% (23 billion out of the 53 billion estimated total value of Irish invested commercial real estate assets).

PwC is concerned that the definition of property funds proposed by the CBI which addresses Irish domiciled AIFs will materially limit the potential efficacy of the proposed measures as a significant proportion of the Irish CRE will not be in scope of the proposed measures.

The proposed measures could lead to a change in the nature of the structures through which Irish property assets are held and not to a reduction in the level of leverage through which such assets are funded. This change could curtail or inhibit the ability of the CBI to monitor the level of financial stability risk in the Irish market. As such the policy objective of the CBI, to strengthen the resilience of the Irish real estate market, and guard against the risk that financial vulnerabilities in the sector amplify adverse shocks in future times of stress, may not be achieved.

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:
In the CP145 consultation document the Central Bank recognised that there is significant diversity in portfolio composition and investment strategies across property funds. The real estate industry invests in, develops, maintains, and supports the real estate assets that constitute the built environment infrastructure that is an essential element of Irish economic, business, and social life. It includes activities such as development; construction; maintenance, repair, and refurbishment of real estate assets.

Since the economic shock of 2007/2008, long term institutional capital has become a much more significant component of the Irish real estate market. These institutional investors include both domestic and international banks, pension funds, insurance companies, specialist private equity firms and Real Estate Investment Trusts (REITS) with the majority of the less senior tranches of capital coming from international sources.

The real estate market is not a homogenous market. Each sub-sector has different characteristics which make it more or less attractive to the different categories of institutional investors over time.

A report on Irish Real Estate Lending Report issued in July 2021 (Source: https://assets.kpmg/content/dam/kpmg/ie/pdf/2021/07/ie-irish-real-estate-lending-2.pdf)

shows the dispersion of credit appetite for investment lending across different real estate asset classes.

For Bank lenders the appetite for LTV's for senior debt ranged from "up to 40%" to "up to 69%" for sectors such as Retail, Hotels/Resorts and Alternative assets and from "up to 59%" to "up to 69%" for sectors such as Office, Private Rented and Industrial/Logistics.

For Non-Bank lenders the appetite for LTV's for senior debt ranged from "up to 59%" to "up to 69%" for the Retail sector, from "up to 69%" to "up to 79%" for the Office and Hotels/Resorts sectors and "up to 79%" for the Private Rented and Industrial/Logistics sectors.

LTV ratios vary both between different sections of the real estate sector and over time. The attached chart from the CASS Business School Commercial Real Estate Lending Report 2020 which covers the period 2015 to 2020 of the United Kingdom market shows how the LTVs have fluctuated across different categories of commercial real estate from 2015 to 2020.

The purpose of loans also varies. Loans secured against existing real estate assets can be split between refinancing existing loans, either by the same lender or other lenders and new acquisitions. Loans can also be advanced for development and can be split between 100% pre-let or partly speculative commercial projects and residential developments either for sale or rent.

In development lending, Loan to Cost (LTC) rather than LTV is the metric which lenders and developers typically use when considering lending in the real estate market. A recent report on Irish Real Estate Lending Report issued in July 2021 shows the dispersion of LTC's aso varied between different lender types across the different sectors of the real estate market.

For Bank lenders the appetite for LTC for senior debt ranged from "up to 40%" to "up to 59%" for the Retail sector, from "up to 40%" to "up to 69%" for the Hotel/Resorts sector and "up to 69%" for the Office, Residential and Industrial/Logistics sectors.

For Non-Bank lenders the appetite for LTC for senior debt similarly ranged from "up to 59%" from some lenders to "up to 79%" for other lenders across the different real estate sectors.

Given the diversity in the investment strategies pursued by Irish Property Funds on behalf of their investors we think that a single leverage limit, irrespective of the type of property holdings is not appropriate as it may have the unintended consequence of disincentivizing certain categories of real estate investors from investing in certain categories of real estate assets or lead to a

concentration of investment in a small number of sub-categories of real estate assets reducing the level of diversification in the market and increasing the level of concentration risk.

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:
Since the Global Financial Crisis regulatory pressures on bank lenders through international Basel standards which require higher capital reserves against loans above 60% LTV has impacted on the ability and appetite of Bank lenders to provide finance to some sections of the real estate market. Non-bank lenders, such as property funds have been willing and able to step into this section of the market to meet the demand necessary in order for these real estate investments to be commercially viable.

When evaluating whether to provide funding for a potential real estate investment, different lender types have different LTV requirements which are based upon the property's market value, the type of property investment being proposed, the investors' risk appetite, the yield or return which the investor requires on their investment and the strength of the covenant from the underlying tenant (which can include State bodies).

Based on the 2020 CRE Lending Report (Source: Table 9, page 38 CASS Business School Commercial Real Estate Lending Report 2020) target lending terms for senior debt in the different categories of real estate assets ranged from 57% to 58%

Acknowledging that this data is for 2020 and based on the UK market the 50% LTV level proposed by the CBI could significantly reduce the ability of the Irish real estate market to attract the

diversity of lenders including a portion of senior debt which it has attracted in recent years thus reducing the benefits for both macroeconomic and financial stability.

The use of the 50% total loan to total asset ratio as proposed by the CBI also has a number of limitations as follows:

The inclusion of total loans in the numerator does not distinguish between the different types of lending institutions who may be involved in the provision of loans to property funds and who may have different objectives and behave differently in times of market stress. Direct or indirect shareholders in property funds that have also provided loans to the funds are far less likely to engage in forced asset sales (and most are in any event unsecured and long term), which could damage their overall return on investment, in times of market stress. We therefore think that loans from shareholders and from parties connected to property fund shareholders should be treated differently from loans provided by commercial banks and excluded from any proposed limit.

As can be clearly seen from the UK data above (Source: Table 9, page 38 CASS Business School Commercial Real Estate Lending Report 2020) for the Retail sector and to a lesser extent the Hotel, the LTV can also be impacted by movements in the market value of the real estate assets included in the property fund portfolio. In order to avoid a scenario where a property fund may inadvertently exceed the 50% LTV limit proposed by the CBI the actual LTV which firms will be able to use for Irish property funds would need to be substantially lower than the 50% level were there to be consequences of exceeding the limits set. In Germany, the new Fund Location Act– Fondsstandortgesetz which came into force on 2 August 2021 provides for more flexibility in the financing of special real estate funds for institutional investors, with the limit for third party borrowings raised from 50% to 60% of the market value of the properties held in the fund. Our German colleagues have noted that, on average, they see external leverage in those regulated fund structures at 45% LTV due to the fact that assets are subject to constant valuation and financing hard on the limit could cause regulatory and tax issues .i.e. a 25% reduction in the actual LTV compared to the max allowed.

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:
We do not think that the proposed measures can feasibly be applied to existing Irish property funds without causing a significant disruption and volatility in the Irish real estate market for the following reasons:

Irish property funds which have invested in a single property asset where the current leverage level is in excess of the proposed 50% LTV level likely can only dispose of the asset and terminate the fund. In such instances it is not feasible to gradually reduce the level of leverage where there is only a single asset in the portfolio. If a large number of Irish real estate assets were to come to the market over a relatively short period of time as a result of a "forced requirement" to dispose of the assets there is a risk that Irish real estate market values could be materially depressed causing the kind of adverse market shock which the proposed measures are designed to address.

Fully drawn funds which have current LTV percentages in excess of the proposed 50% level will not be in a position to access additional equity funding to allow the orderly reduction in the LTV level below the 50% level and will also be "forced" to dispose of real estate assets which may also lead to the kind of adverse market shock which the proposed measures are designed to address.

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:
Where the CBI proceeds with its proposal to implement a leverage limit for Irish property funds we agree that the CBI should have the ability to temporarily remove the limit, in response either to large, unanticipated adverse price shocks and/or significant overheating as the failure to do so, resulting in the need for Irish property funds to engage in forced assets sales in a falling market would amplify the shock to the real estate market and the Irish economy.

However, in the first instance we believe that, where a leverage limit is imposed by the CBI, the leverage limit should be established at a level such that the CBI should only ever need to adjust the leverage limit in response to significant unanticipated adverse price shocks and/or significant overheating and that the level at which such measures would be activated, and the procedures and consultations to be undertaken by the CBI in advance of their activation, should be fully disclosed in the relevant regulation. The leverage limit set should include a sufficient buffer such that non-stressed levels of asset price volatility should not trigger the need for large numbers of funds to engage in the kinds of remedial measures which could further damage the market.

Secondly, the added uncertainty created in the market, by the imposition of a leverage limit by the CBI, which may then be subject to further adjustment, even on a temporary basis, may give rise to the scenario that the anticipation of the change in the leverage limit by market participants is an amplifier of the risk that CBI is seeking to address. Individual investors or lenders seeking to avoid the scenario of having to act in a "forced" scenario may preemptively act to withdraw funds or facilities leading to a potential self-fulfilling feedback loop between individual market participant behaviors to avoid adverse price shocks and/or significant overheating events and the conditions that lead to such market shocks or events.

Lenders into the real estate market are sophisticated and experienced and accordingly the terms of any loan agreement will already contain specific covenants and triggers in respect of the LTV or other metrics that measure the performance of the asset more generally. Where there is a market event or risk of overheating or a particular development, it is likely that action will already have been taken in accordance with the terms of the loan agreement and

accordingly adjusting the leverage limit or relying on the CBI to implement a change to permitted levels, could itself cause a market event.

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:
The financial stability and market integrity are key objectives of the AIFM Directive (2011/61/EU) (the'AIFMD'). The AIFMD introduced tools to improve macro-prudential monitoring and supervision of financial stability risks. AIFMs are required to report to supervisors on the main AIF exposures, their liquidity profile and leverage. Supervisory reporting has supported effective macro-prudential supervision and it is helpful for market monitoring.

The AIFMD has also created an effective supervisory cooperation network coordinated by the European Securities and Markets Authority '˜ESMA'), which is contributing to the convergence of supervisory approaches to the AIF activities in the European Union.

The AIFMD has become a significant pillar of the Capital Markets Union '˜CMU') thanks to the ability of investment funds to offer access to market-based sources of financing and to enable investors to better allocate their savings over the chosen time horizon in accordance with their preferences.

The European Commission has stated that regulatory fragmentation, where national frameworks are established to govern certain aspects of the market, can lead to difficulties in identifying and reacting effectively to potential market wide effects that may result from the activities of certain funds. Moreover, diverging national regulatory approaches undermine the establishment of an efficient internal market for AIFs by promoting regulatory arbitrage and varying levels of investor protection.

In November, 2021 the European Commission issued a proposal for an amending Directive to the AIFMD which contains measures

regarding availability and use of Liquidity Management Tools '˜LMTs') during times of market stress. The possibility to activate LMTs can protect the value of investors' money, reduce liquidity pressure on the fund and mitigate against broader systemic risk implications in situations of market-wide stress.

In addition to being able to suspend redemptions, AIFMs will have to choose at least one other LMT from Annex V (which will be a harmonised list across the EU). AIFMs will need to notify competent authorities (NCAs) about their use of LMTs. The proposals also include the power for the competent authorities to require the activation or deactivation of an LMT. ESMA is to develop draft RTSs to provide definitions, and specify the characteristics, of the LMTs and guidance on selecting and using suitable LMTs.

We therefore think that the liquidity measures being proposed in the amendments to the AIFMD should be sufficient to equip both Irish AIFMs and NCAs such as the CBI with the necessary tools to appropriately manage liquidity risk in Irish property funds in times of market stress. As such, no additional measures are required at this time.

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:
Approximately 60% of Irish real estate funds have been structured as closed-ended funds under the Qualified Investor Alternative Investment Fund (QIAIF) regime, whereby the investors are required to be sophisticated and/or professional investors in order to invest. The closed-ended funds, due to their nature, do not give rise to liquidity mis-match as redemption mechanisms are not a feature available to investors and therefore these closed-ended funds should be deemed out of scope for these purposes.

Of the remaining QIAIF's, whilst open-ended in nature with redemption capabilities, the funds' constitutional documents prescribe detailed limitations in the redemption notice and settlement timeframes specified to the qualified investors, due to the illiquid nature of the real estate assets and goes further by stating that redemptions are still ultimately at the discretion of the AIFM depending on the market conditions at that time.

On 25 November 2021, the European Commission (the "Commission") published its legislative proposal for AIFMD2 (the "proposal"). One of the key takeaways from the proposal was liquidity risk management.

As anticipated, additional liquidity risk management provisions are proposed, including a list of liquidity risk management tools which national competent authorities must make available to AIFMs. The proposal introduces the requirements for AIFMs that manage open-ended AIFs to select at least one appropriate liquidity management tool from a prescribed list to be included on an Annex to the Directive. The proposal confirms that AIFMs managing open-ended AIFs may, in the interests of investors, temporarily suspend the purchase or redemption of AIF units in exceptional circumstances.

We therefore think that the liquidity measures being proposed in the amendments to the AIFMD should be sufficient to equip both Irish AIFMs and NCAs such as the CBI with the necessary tools to appropriately manage liquidity risk in Irish property funds in times of market stress. As such, no additional measures are required at this time.

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:
No response provided.

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:
As a result of the uncertainty which the introduction of the proposed regulatory change adds to the market and the ongoing uncertainty as to the level of leverage which the CBI will permit Irish property funds to hold there is a material risk that the proposed measure in relation to the imposition of a leverage limit of 50% will lead to a change in the nature of the structures through which Irish property assets are held reducing the ability of the CBI to monitor and supervise the market. It will encourage the higher leveraged transactions and strategies to move to less regulated parts of the market and thereby inhibit the ability of the CBI to safeguard the resilience and financial stability of the Irish real estate market.

As noted in the recently published CBI Market Based Finance Monitor 2021, market based finance from participants such as investment funds provides a valuable alternative to bank finance for many businesses, including real estate developers and investors, and supports economic activity. The CBI's proposal to reduce the level of leverage which Irish property funds can hold will reduce the attractiveness of investing in Ireland to international investors and may lead to an increase in the level of concentration risk to bank finance with a return to greater share being provided by domestic banks.

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:
No response provided.

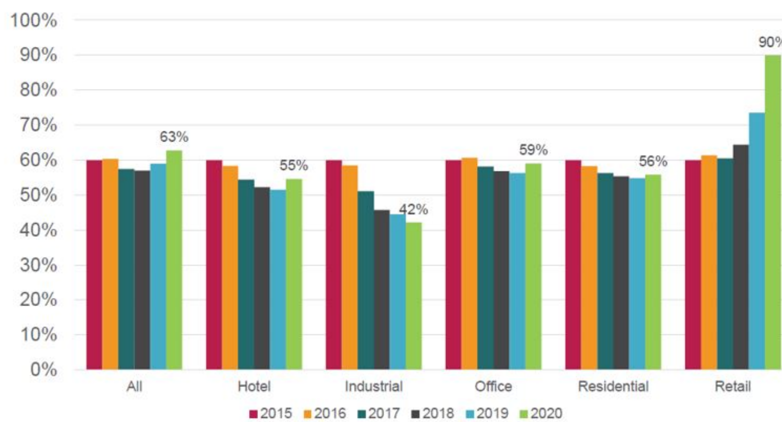
If there are any significant operational difficulties envisaged by AIFMs in complying with the draft guidance (Annex 1 of CP 145),

please provide brief details, including any possible solutions if appropriate.

Response:
No response provided.

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.

The proposal to make significant and retrospective changes to the regulatory regime concerning a medium to very long term asset class such as real estate will further erode international investor confidence in the Irish real sector. This erosion of confidence manifests itself in 1 of 2 ways - (1) an additional risk premium i.e. higher costs in the delivery of new real estate assets in Ireland or (2) the withdrawal from the Irish market by some of the market participants leading to concentration risk. Neither of these outcomes are welcome at this stage in the economic cycle when Ireland is looking to draw additional capital and players into the sector to

maximise the diversity of funding sources available and increase the supply of real estate assets, especially residential.

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