Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Macroprudential Policy for the Property Fund Sector – Consultation Paper 145

Feedback from Savills Commercial (Ireland) Limited

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:
Savills Commercial (Ireland) Limited disagrees with the proposals regarding the cap on leverage for property funds.

We believe the arbitrary cap on leverage would create many unforeseen problems within the commercial real estate sector. Through this submission, we question whether these proposals are necessary. If the proposals meet the CBoI's objective "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:

- We disagree that the proposed measures improve the sector's resilience and believe it could amplify risks in times of stress.

- Handicapping leverage reduces the potential to meet market return expectations, reduces international competitiveness and increases the perceived regulatory and political risk of Ireland's CRE market. As a result, the proposed approach may encourage international investors and lenders to reduce their participation in the Irish market. The CBoI highlights that Ireland has had the largest CRE value peak to trough fall in Europe. We believe that the greater participation of foreign institutional capital in Ireland through equity and debt has produced greater stability in the CRE sector. Higher leverage private equity funds accounted for 36% of market transactions between 2012 and 2016, providing significant support to a market in need of liquidity. Any proposals to limit leverage will actively contribute to the fragility of the market through the reduction of participants and impact the CRE sector's ability to respond to a correction.

- The proposed testing of leverage limits throughout the entirety of the loan suggests that Central Bank regulations could be broken due to falling property values. In future periods of stress, this may force long-term stable property holders to sell assets to meet Central Bank requirements amplifying the sector's response to a downturn. We would expect new lenders to respond to the proposed regulatory changes by restricting leverage to significantly below the proposed cap to prevent the forced selling of assets due to the breach of Central Bank lending proposals. Further amplifying the impact of the cap and economic viability of many transactions.

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 target of the leverage limits at property funds.
- Imposing leverage limits on funds captures only part of the investment market. This unfairly punishes mostly institutional and foreign capital. Targeting this sector may encourage these investors to reduce their participation in the Irish CRE market, which wouldn't benefit a market; that's resilience has been strengthened in recent years by the increased participation of these very funds.
- An unintended consequence of targeting property funds may force investors to use alternative vehicles and structures to invest in the market. Shifting investment from more

transparent sources to less transparent and less regulated market elements. This would reduce the ability of the Central Bank to monitor the CRE sector and not necessarily impact the levels of leverage in the market.

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:
We disagree that a proposed single leverage limit is responsible in the current marketplace.

- The single leverage limit proposed to improve the resilience of property funds is overly simplistic in the modern commercial real estate sector. A set leverage limit is just one variable in analysing the risk of a property funds ability to weather market turmoil. Interest rates, debt costs, tenant covenants, and sector performance all impact the financial performance of CRE. Therefore, despite the increased regulatory burden, it's appropriate to consider these metrics when analysing whether property funds are likely to be able to absorb market shocks.
- Any imposed strict single limit on leverage may have unintended consequences in the CRE market. Different market strategies require different debt tolerances, and higher leverage can be a normal response to investment positions. Higher leverage is more likely to be prevalent in development and reposition strategies than stable and operating core properties. Therefore, we would think it would be prudent to offer different leverage levels to assets going through construction or major refurbishment projects, as they are using debt to fund expenditure that seeks to enhance the value of assets rather than help finance the acquisition. Any use of leverage in these contexts helps make these riskier CRE strategies financially viable. This type of finance in relation to

these strategies is increasingly important as the state responds to the need for greater housing supply, whilst also acknowledging that this sector already faces lending constraints on buyers through the residential macroprudential rules. Leverage caps may also impact the state ability to meet its commitments to climate-related retrofitting and the demand for ESG compliant assets.

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:
  No, we consider 50% too low compared to typical levels of finance in the market. Senior debt financing in Ireland and other developed markets typically range from 50-65%. Any cap below this range would significantly restrict the market from necessary financing for stable properties.

- We believe market lending decisions adequately reflect the cycle, risk, and the lenders' individual exposure. An open marketplace restricts risk exposure in times of shock and opens liquidity when markets recover after downturns. Any cap on leverage prevents the lender's ability to change market exposure through the cycle and, therefore, could restrict the market from reigning in risk as market shocks approach. But more crucially, a 50% cap prevents the market from reacting to new market cycles, elongating and amplifying shocks.

- We acknowledge that a 50% cap would align our leverage terms with Germany's. However, suggesting Ireland's investment volumes won't be adversely affected because this was the case in Germany is flawed and overly simplistic. As evidenced by the difference in prevailing yields in both markets (Ireland's prime office yields 4%, Germany 2.7%), there is a significant risk premium attached to investing in Ireland compared to Germany. Investors need to be compensated for the additional risk; leverage is one way that this can be achieved. Furthermore, Germany's investment market is more mature, with more diversity in lenders and property funds. We remain concerned that any cap would reduce participation in Ireland's CRE market, reducing competitiveness in the marketplace and ultimately amplifying shocks.

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:
No, this transition period is far too short when considering the standard terms of senior lending. Considering that fully drawn funds could have entered into senior loans at 65% LTV with 1% amortisation, a three-year transition period would suggest they would have to significantly increase their amortisation to meet the 50% cap, and it is highly unlikely the underlying asset cash-flow could support such a paydown in the timeframe.

This would impact the viability of the fund's strategy and change the structure and associated risk of the loan. If this couldn't be achieved in this time period, funds would have no alternative to sell assets to meet the limit. The potential buyer pool for such assets could also be restricted as a result of the proposed leverage limit, with potential investors in fund structures at a competitive disadvantage with the proposed leverage cap. This could have the consequence of reducing the buyer pool for asset classes, meaning the market is more illiquid and has less stability.

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 leverage limits are overly heavy-handed and inherently destabilising.

We believe the market can self-regulate and adjust risk tolerance based on market cycles. Any competitive and transparent lending market should adjust risks in times of significant overheating and encourage lending in new market cycles. Any policies that can help create a transparent marketplace and help lenders identify additional risks in the marketplace should be encouraged to allow the free market to make these decisions.

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

Response:

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

Response:

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

Response:

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

Response:

If there are any significant operational difficulties envisaged by AIFMs in complying with leverage limits imposed via Article 25, please provide brief details, including any possible solutions if appropriate.

Response:

If there are any significant operational difficulties envisaged by AIFMs in complying with the draft guidance (Annex 1 of CP 145), please provide brief details, including any possible solutions if appropriate.

Response:

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

Response:

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

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