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Deputy Pearse Doherty
Leinster House
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Dear Deputy Doherty

I write in response to your recent correspondence on property investment funds. As your correspondence was copied to the Minister for Finance, I will forward the Minister a copy of this response. While I am precluded from discussing any individual firm or entity, I can give a clear overview of how the Central Bank, as the national macroprudential authority, assesses and seeks to mitigate systemic risk and deals on a microprudential level with institution-specific risk for those firms regulated by the Central Bank.

As part of our regular monitoring of systemic risk and financial system surveillance, the Central Bank of Ireland pays particular attention to developments in Irish real estate markets – both the Residential Real Estate (RRE) and Commercial Real Estate (CRE) markets. The priority of the Bank is to ensure the stability of the domestic financial system and to promote the resilience of domestic lenders and borrowers to any shocks to real estate prices, whether these result from the presence of global investors and their sensitivity to global or foreign developments or other sources. Where the Bank identifies concerns, we can deploy both macroprudential tools – aimed at preventing system-wide risk – and microprudential tools – aimed at individual regulated financial firms.

Micropudential and macroprudential tools

At a microprudential level, the Central Bank operates a risk-based system of supervision of regulated firms, under which the most significant firms - those with the greatest impact on financial stability and the consumer - receive the highest level of supervision under structured engagement plans, leading to early interventions to mitigate potential risks. This assertive risk-based approach to supervision is supported by a credible threat of enforcement. The Bank's enforcement strategy is aimed at promoting principled and ethical behaviour in regulated entities and those that work in such entities.

At the system-wide level, the Bank's macroprudential policy actions are subject to regular review to ensure their effectiveness in promoting the resilience of the domestic financial system. This process includes general surveillance of the macro-financial environment and identification of systemic risks, as communicated in our bi-annual Macro-Financial Review. There is also specific analysis related to real estate markets that features in the quarterly review of the Counter-Cyclical Capital Buffer (CCyB) and the annual review of the macroprudential mortgage market measures.

With regard to residential real estate, one of the primary objectives of the mortgage measures in place since 2015 is to enhance both bank and borrower resilience by limiting the volumes of high loan-to-value (LTV) and high loan-to-income (LTI) mortgage lending. Following the most recent review in November 2017, the core parameters of the measures remain unchanged and these measures are expected to contribute over time to reducing the loss-given-default and probability of default on RRE exposures, hence enhancing the resilience of the financial system.

In the CRE segment, the Central Bank has mandated minimum risk weights of 100 per cent on the CRE exposures of banks accounted for under the Standardised Approach since 2007, which is higher than the 50 percent minimum risk weight applicable under the benchmark requirements of the Capital Requirements Regulation (CRR). This requirement covers approximately 25 per cent of the entire CRE exposures of the Irish banking system, and means that banks must hold an amount of capital on their balance sheet equal to the size of those exposures. On top of that, the model-based risk weights for banks using the alternative Internal-Ratings Based (IRB) approach, which account for approximately 75 per cent of CRE exposures, are relatively higher for Irish than other European institutions given the historic loss experience during the last crisis.

Overview of Irish property market

Funds (including international and Irish authorised funds) and Real Estate Investment Trusts (REITs) have been particularly active in the Irish property market in the period since 2012. While private equity investors, retail funds and Irish-listed REITs were to the fore initially, there has been a notable shift in investor profile of late with evidence of more long-term institutional investors, such as international insurers, property companies and income-orientated and pension funds.

Total returns from Irish commercial real estate have moderated in recent years (bringing them more in line with other international markets), as the focus of the investment market has switched to generating returns from income and rental growth as opposed to a focus on short-term capital gains. According to market intelligence, long-term institutional investors ultimately tend to be more disposed to such an environment.

On the residential side, non-household buyers, which include investment funds, have become increasingly important market participants, accounting for just under 15 per cent of all residential housing transactions. Reflecting in part the prominence of non-household buyers, the proportion of non-mortgage financed transactions is estimated to account for up to 55 per cent of total residential property transactions in H1 2017. Prices related to those non-mortgage financed transactions appear to have risen at a faster pace than prices for mortgage-financed transactions and are contributing to overall price dynamics in the market.

The investment of REITs and property funds in new residential and commercial property development is also playing a role in helping to address the housing shortfall and, until relatively recently, the scarcity of office space. Compared to a scenario in which property investment is exclusively funded by the domestic banking system, more diversified sources of funding and a greater range of investor types may enable improved management of the risks that are inherent in real estate markets.

A greater degree of international investor involvement in the real estate market does imply that market conditions may be affected by shifts in global investor sentiment to the Irish property market or a change in external financing conditions. Under these circumstances, it is important that domestic banks that retain significant portfolios of outstanding residential and commercial real estate lending are resilient to any drops in collateral values that could arise if there were to be a significant reversal in foreign investment flows.

In the instance of both RRE and CRE, as stated above, the Central Bank continues to monitor market-wide developments closely. Microprudential policy actions are taken as appropriate at institution-specific level. As the macroprudential authority, the Central Bank regularly reviews its macroprudential policy tools and will adjust them as may be appropriate, to ensure that they continue to remain relevant and effective in promoting the long-term sustainability of Irish mortgage lending and broader resilience of the domestic financial system.

Yours sincerely

Philip Lane