CREFC Europe

CP145 – Macroprudential measures for the property fund sector

Response (as inserted into the online response form of the Central Bank of Ireland ("CBI"))

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?

No, we do not agree. (Please note that our submissions focus solely on the proposal to limit leverage. Given the expertise and market orientation of CREFC Europe as a trade association for real estate finance markets, we are not commenting on the proposals relating to liquidity mismatches.)

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 share that concern.

However, we believe the leverage limit as proposed would not achieve the CBI's policy aims. Unless significantly modified, it would be likely in our view to have unintended and undesired consequences, reducing (rather than improving) the ability of market participants to manage cycle risk and increasing the risk of (otherwise avoidable) forced sales.

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:

- setting the limit at just 50% when the normal senior lending LTV range (in Ireland as in other comparable markets) is in the 50% to 65% range;
- the inclusion of shareholder debt (a questionable policy option, and one that affects only pre-existing funds – see further (2) below); and
- 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.

The Irish real estate market is broader on the equity side than the "property funds" on which the CBI has power to impose its proposed measure, and (as noted in para 4.2 of CP145) it is also broader in terms of sources of credit than the firms within the CBI's regulatory perimeter. It is therefore unavoidable that a regulatory leverage limit creates a risk of regulatory arbitrage. By restricting leverage in the most regulated part of the market, the CBI is, in effect, encouraging higher leverage transactions and strategies to move to less regulated parts of the market.

As values in the regulated part of the market can be affected by values in the less regulated parts of the market, the protection that intervention provides even for the directly affected part of the market is limited. Firms to which the leverage limit applies would be vulnerable to market stress originating in the part of the market to which the leverage limit does not apply. As a result, even firms that would be comfortable with a reasonable leverage limit if they could ensure compliance with it may choose to structure their Irish property investments outside the Irish AIF sector, to avoid being a hostage to fortune (on this, see further (3) below).

Rather than imposing a crude leverage limit on part of the market, the CBI might usefully drive the availability of better property cycle information to the whole market. That principle was at the heart of Recommendation 4 of the 2014 independent industry report, "A Vision for Real Estate Finance in the UK" and subsequent related work, available here: https://www.crefceurope.org/committee/9.

(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 periodically throughout the life of the loan.

A leverage limit tested only when a loan is entered into could enhance market resilience because market participants would be safe in the knowledge that, having complied with it, it could not operate to force them into asset sales because of matters outside their control (such as a property market crash). Initial leverage could be at a level deemed acceptable by the CBI, and the transaction parties would be free to deal with stress (whether market wide or affecting their specific asset) in accordance with their contractual arrangements and commercial judgment. In particular, the lender would retain the ability to use financial covenants as intended, with the flexibility to decide how to respond to any breaches.

By contrast, we understand the CBI to be proposing a leverage limit that would be tested periodically, and which could therefore be breached as a result of falling property values. We do not understand how that can possibly enhance market resilience – on the contrary, it would surely only serve to reduce it.

In relation to existing loans, a regulatory 50% limit would be tripped before any LTV-linked financial covenant in the loan documentation. It would therefore undermine, retrospectively, the lender's ability to manage its exposure to the asset and its relationship with the borrower. In most cases, too, the leverage limit would be tripped at a time when the property fund is fully drawn and has no access to additional equity, so the only viable response would be a

forced sale. It is difficult to see how a leverage limit structured in this way would not place a lot of pressure on the CBI to intervene to prevent widespread forced sales.

For new funds and loans, the problem would be a different one – to reduce the risk of tripping a 50% regulatory leverage limit because of market movements outside the control of the parties, initial leverage would almost certainly be set significantly below 50%, raising the cost of capital and impacting the economic viability of many transactions. If the CBI would like to see funds using leverage of no more than around 50%, the limit needs to be set at a significantly higher level, allowing a buffer. (We would argue that the explicitly counter-cyclical approach embedded in Recommendation 4 of the Vision report, referenced at (2) above, would be better than any simple, single LTV number, which inevitably means different things at different points in the property cycle.)

(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 restructuring or selling assets. It is unclear what benefit is conferred by forcing such funds to go through the hassle and cost of restructuring, assuming that can be done; and the alternative of forced asset sales is precisely what the proposed measure is seeking to avoid.

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.

Finally, as discussed in our submissions below, there are economic implications of a regulatory leverage limit in the property sector which could (if the financial stability benefits are not compelling) bring it into conflict with the CBI's mission to ensure that the financial system operates in the best interests of consumers the wider economy.

Leverage can be an essential element of the capital mix in achieving viability for transitional property (such as decarbonisation retrofit, repurposing and repositioning) and for construction projects, including for housing. International and institutional investors, through regulated funds, are currently playing a key role in addressing the housing crisis in Ireland, e.g. through delivering increased residential supply for local authorities which enables them in turn to fulfil their social housing commitments. The Irish government in its Housing for All (HfA) Q4 2021 Progress Report explicitly acknowledges the critical funding role that institutional capital must play if HfA targets are to be met (see https://www.gov.ie/en/publication/84e61-housing-for-all-q4-2021-progress-report/, page 6).

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

Firstly, as mentioned in section (2) of our response to the previous question, we are concerned at the arbitrage risk created by the proposed reliance on this definition to set the scope of the leverage limit. The CBI does not adequately explain why targeting this, the most institutional, international and well-regulated part of the market makes sense – save by reference to its power to do so. CP145 rightly 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.

Did the CBI consider other approaches that might not have the weaknesses of, or be vulnerable to the unintended consequences likely to arise from, an approach that adds to the regulatory constraints on this part of the market? Even the best designed measures imposed on only part of the market would create arbitrage risk (and the proposed leverage limit is not in our view well designed), encouraging activity to move to a different part of the market beyond the effect of the measures. Not only those strategies, investors and funds seeking higher leverage (including for entirely legitimate and socioeconomically positive reasons) would choose to operate using different vehicles and structures. So would more conservative strategies, investors and funds, because the design of the proposed leverage limit means they cannot eliminate the risk of a disruptive breach during the life of the fund, after capital is fully drawn and invested, for reasons entirely outside their control (a point discussed in section (3) of our response to the previous question).

We would recommend, instead, a focus on improving the property cycle information available to the entire market, building on the analysis of property cycle risk in the 2014 report, "A Vision for Real Estate Finance in the UK", especially Recommendation 4 and subsequent related work (available here: https://www.crefceurope.org/committee/9). Unlike the proposed measure, such an approach would present no arbitrage risk, and would be actively countercyclical, restraining excessive leverage in a boom but not in a bust. Finally, it would go with the grain of self-interest by making it easier for all strategies, investors and funds to use leverage in a way less likely to cause problems for them (as well as for market stability).

We see two possible undesirable 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 regime 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. As explained above, we would expect to see both high leverage and more conservative strategies react in this way. 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.

We would also like to comment on another, more detailed aspect of the approach to, and definition of, "property funds" for the purposes of this measure.

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 to put property-backed secured debt in the asset-holding vehicle, and not at the level of the fund vehicle. One would therefore fully 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.

This can clearly be seen in the CBI's Deep Dive Survey data as presented in Chart 2 (Distribution of property assets by property funds' leverage) on p10 of CP145, with most instances of high leverage found in so called "single investor funds". (That is the case both when only true, third party debt is taken into account, and when shareholder debt is also included.) The use of leverage by these "single investor funds" cannot meaningfully be compared to the use of leverage by German Spezialfonds, which are typically used as the parent investment fund vehicle (we understand, by the way, that the leverage limit for non-retail Spezialfonds has, in fact, recently been increased from the 50% cited in CP145 to 60%).

Irish ICAVs that are "single investor fund" AIFs would be more appropriately compared to the Jersey property unit trusts (JPUTs) and other property-holding single purpose vehicles (SPVs) that are widely used in commercial property markets. While we do not have data to substantiate this, we are confident that such entities typically have higher average leverage than parent fund entities like Spezialfonds; and we are not aware of markets in which the use of leverage by such (i.e. asset-holding) vehicles in the institutional investment context is regulated in the way proposed by the CBI.

If these factors are recognised and the distortions to which they give rise disregarded, we believe, based on what our members tell us and broader, anecdotal evidence, that leverage in the Irish property funds market is broadly in line with leverage in other, comparable markets. Typical LTV levels obviously vary, depending on the nature of the asset and the financing. For example, very prime assets tend to use less leverage than more secondary or transitional assets. But we would regard leverage in the 50% to 65% LTV range as common, and not generally excessive, in both the Irish market and other comparable markets.

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)?

It is difficult to balance the attractions of simplicity and clarity, on the one hand, against the benefit of greater sensitivity to the range of different strategies and requirements in a highly heterogeneous market. We consider that the best solution would be to design the leverage limit in such a way that only true outliers were likely to fall foul of it. In particular, if it is set at the right level (significantly higher, we would argue, than a regularly tested 50% LTV), we would agree with the proposal for a single leverage limit.

If however the CBI insists on a 50% limit, especially if on a basis that is regularly tested rather than tested only at inception, it would be advisable to take on the difficult task of identifying and defining those parts of the market to which a different (higher) level should apply.

Higher leverage can be a sign of risk build-up, but it can also be the natural and sensible response of investors and lenders to higher risk investment propositions. Different assets and strategies, and the cost of capital of the investors and lenders they attract, can legitimately lead to very different 'natural' leverage requirements.

For example, a build-to-rent housing development might attract not only senior debt from a bank, say, but also mezzanine debt from a debt fund managed by a firm with extensive experience of owning and operating buildings, reducing the blended cost of capital for the equity behind the developer and helping the project achieve economic viability. By contrast, a new office building in a prime location may be easy to fund with little or even no leverage.

Similarly, a regulatory LTV cap of 50% might mean that the socioeconomically important (but relatively risky) repositioning of an asset in a secondary location ceases to be viable. At the same time, that LTV cap may have no impact at all for the (socioeconomically less important) sale and purchase of a fully let building in a prime location.

However, we would not relish trying to carve up and apply differentiated treatment across markets that are very heterogeneous and diverse, both in terms of underlying assets and their uses, and in terms of sources of capital and investment structures.

It would be better, instead, to get the design and level of the leverage limit proposals right. As noted above, we are most troubled by (1) the lack of grandfathering for existing funds and (2) the use of a periodically tested leverage limit that is likely to drive investment in Irish property away from the AIFMD framework, constrain lenders' contractual flexibility and force sales by borrowers.

We could support a single leverage limit set at 65% LTV that applies only to new loans, and is tested only when a loan is made (and the parties to it can ensure compliance), as that would preserve the ability of the transaction parties to find the best commercial solution for dealing with stress.

Any limit that is tested periodically throughout the life of a loan/fund should be designed so as to allow time for cure, and avoid forcing rushed asset sales. For example, failing the test

once should serve as a warning that action (or a recovery in the market) is required during the subsequent two or three year period, and only if the test is failed again after that period should corrective action be required.

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.

This point is also relevant in the housing context. International and institutional investors, through regulated funds, are currently playing a key role in addressing the housing crisis in Ireland, e.g. through delivering increased residential supply for local authorities which enables them in turn to fulfil their social housing commitments. The Irish government in its Housing for All (HfA) Q4 2021 Progress Report explicitly acknowledges the critical funding role that institutional capital must play if HfA targets are to be met (see https://www.gov.ie/en/publication/84e61-housing-for-all-q4-2021-progress-report/, page 6).

Has the CBI considered the interaction between its proposed leverage limit and real estate cap ex funding needs (especially for decarbonisation and building homes)? Steering capital (especially institutional capital with a longer-term investment horizon) away from socioeconomically valuable investment should not be regarded as an acceptable price for a (highly uncertain, in our view) reduction in macroprudential risk associated with the sector.

Finally, a leverage limit would be most effective in pursuit of the CBI's stated policy goals if it operated in such a way as never to be tripped other than by highly leveraged outliers. The best approach – discussed in more detail in our response to the next question – would be to develop indicators of cyclical overvaluation along the lines suggested by Recommendation 4 of the 2014 report, "A Vision for Real Estate Finance in the UK" (that report and related materials can be found here: https://www.crefceurope.org/committee/9).

The mere existence of such tools and CBI backing for them would help avoid the kind of market stress the CBI is concerned about. The positive impact of such an approach would reach far beyond the CBI's regulatory perimeter and the Irish property AIF sector: sensible borrowers and lenders, regardless of regulated status, would make use of the information such tools could provide. Such tools could also be used to set leverage limits for Irish property AIFs at an appropriate, cycle-sensitive level, to be tested at loan inception only. That would be a more effective (as well as more proportionate) way of addressing the CBI's policy objectives.

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.

No, we consider 50% too low for a number of reasons, discussed below, but also specifically compared to typical levels of senior debt finance in both Ireland and other developed markets in the 50% to 65% range (depending on the precise market and the point in the cycle). We explained in our response to the second question above why we think it is incorrect to consider the Irish property market to be significantly more highly leveraged than other comparable markets. But our concerns go beyond the specific number proposed.

First, as outlined above, we believe that any leverage limit should operate as a day one test only, so that transaction parties can ensure they comply with it (and need not worry about breaching it thereafter because of matters outside their control).

It would be impossible for transaction parties to control their compliance with a limit that is periodically tested throughout the life of a fund/loan. It is likely that the market would respond to that uncertainty by restricting initial leverage at significantly lower LTV levels, or by maintaining an equity cushion as a safety buffer. Either of those responses would increase the cost of capital and reduce the economic efficiency of capital deployment and investment. A periodically tested 50% LTV limit seems certain to condemn many repositioning, repurposing, decarbonisation and housing construction transactions to non-viability, at least within the AIFMD framework. Responsible market participants would be wise to aim for much lower initial LTV levels than 50% to avoid the risk of a breach later. Insufficient leverage to balance out the high returns demanded by equity in the construction, transitional and higher risk parts of the market would mean a great deal of this kind of activity cannot take place within the relatively well-regulated AIFMD framework.

Secondly, and more fundamentally, we refer the CBI to the 2014 independent industry report, "A Vision for Real Estate Finance in the UK", which made recommendations to the Bank of England for reducing the risk of damage to the financial system from the next commercial real estate market crash (available here along with related materials: https://www.crefceurope.org/committee/9). That report argued that LTV as a risk measure has to be seen against the backdrop of a cyclical and volatile real estate market:

> "Market value based LTV reflects the cycle, so lending decisions linked to such a measure will tend to feed the cycle and increase exposure to it. That is a fundamental flaw when it comes to assessing and managing cyclical risk and protecting financial stability. This problem could be substantially mitigated if LTV was calculated by reference to the long-term value of the property supporting each loan, rather than its point-in-time market value."

Developing long-term value data and tools to help all market participants better understand where we are in the cycle – even with no compulsion – would do far more to improve market stability than imposing a regulatory, market value-based LTV cap on part of the market. The Vision report recommended that the eventual goal should be to build long-term value metrics into regulatory capital charges. The report specifically considered, and rejected, the idea of LTV caps:

> "Any regulatory approach that operates by reference to market value based LTVs is flawed because of the inherently and inescapably pro-cyclical behaviour of market values. A separate question is whether high (even long-term value based) LTV lending should be banned altogether, rather than being a determinant for the calibration of capital requirements. The strong recommendation [of the group behind the report] is against the use of outright LTV caps, because they are more constraining than is required to protect financial stability, without providing any additional protection, and with a risk of unintended consequences. A regime that gradually increases the regulatory capital requirement as long-term value based LTVs exceed specified thresholds is greatly to be preferred."

We agree with that analysis.

Thirdly, we are concerned that the approach proposed by the CBI, basing its LTV limit on market value, would inevitably lean very heavily on valuations, and valuation is an inexact science. We understand that it is not uncommon for assets to sell for a price that is more than 10% higher, or lower, than the most recent valuation. The proposed measure would put a lot of pressure on valuers and their valuations, particularly during times of market stress when transactional activity may be limited and values especially uncertain. A way of reducing that pressure would be to adopt a phased approach to the application of the leverage limit, as suggested above – namely, that a breach starts the clock ticking on a two or three year period, allowing a reasonable opportunity for steps to be taken to cure the breach (or for a temporary period of market stress to pass).

Fourthly, if existing loans are not grandfathered and excluded from the scope of the proposed measure, a leverage limit of 50% would cut across the LTV-linked financial covenants used by lenders. For lenders, such covenants provide information and, crucially, allow flexibility of response. A lender can allow the covenant not to be tested at all during challenging conditions that it believes to be market-wide and temporary – this was very common (and welcomed) during the height of the pandemic, for example. When such a covenant is tested, a breach provides a trigger for a discussion with the borrower, with a range of options usually being available to protect the lender's position (from heightened information requirements and cash trapping to the injection of new equity or enforcement action). That flexibility is important, and would be undermined by a leverage limit set by the CBI at a level (50%) significantly lower than would typically apply under commercial loan documentation.

In other words, introducing a 50% leverage limit would create problems not only for the international and institutional investors whose equity is invested in Irish property AIFs, but also for the many lenders (banks and non-banks, domestic and international) that provide loans to Irish property AIFs. This concern could alternatively be addressed by grandfathering existing funds and loans already in place so that they are not affected by the proposed measure. Otherwise, the regulatory leverage limit should be at a level that would not be triggered before lender covenants, other than in true outlier cases.

Finally, we are aware that Irish REITs are subject to a periodically tested 50% leverage limit. However, that limit is justified as an investor protection measure, given that REITs are listed vehicles available to retail investors. AIFs, by contrast, are institutional fund vehicles. Moreover, the leverage limit for REITs applies at the level of the REIT, not its individual asset holding subsidiaries. Furthermore, REITs are fundamentally very different vehicles than AIFs in

terms of their access to capital and ability to manage their capital structure. For all those reasons, we do not consider the REIT code to be a relevant or useful guide for how the CBI might address its macroprudential concerns about leverage in the property funds market.

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

No. Fully drawn funds that have already acquired assets and entered into loans will not have access to additional equity, so will have no alternative but to sell if the limit is breached (either at the outset or as a result of market movements). Existing funds and loans should instead be grandfathered and excluded altogether from the scope of the proposed measure. Failing that, the transition period should be set at a length that would effectively grandfather existing funds – in our view, at least five years.

As mentioned in our response to the previous question, for loans already in place, a regulatory leverage limit of 50% LTV would be triggered before the LTV-linked financial covenants typically found in commercial loan documentation. In some cases, the only solution for the borrower would be to sell assets, which might run counter to the wishes of the lender as well as the borrower, which would find itself retrospectively prevented from executing its investment strategy.

The scope for existing funds that have drawn and invested capital and raised debt secured on their assets to deleverage "in a gradual and orderly manner" is likely to be very limited in practice. 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.

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?

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 unless LTVs at loan inception fall far below the level of the limit. 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 (and should be encouraged to exercise) through credit underwriting, financial covenants and judgment in loan servicing.

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 maintaining significant equity buffers makes no economic sense) forced sales. Introducing a measure that inevitably entails that risk, and thus the need for a regulatory power to counter it, may encourage some market participants to assume that the power would be used, undermining the effectiveness of the measure. It would be better to manage the risk of excessive leverage differently.

A lender's *ex-post* power to use an LTV covenant breach to renegotiate terms (and to 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). Whereas each lender can fine-tune its decisions according to the borrower and asset, the CBI would be confronted with an all-or-nothing choice to exercise its power.

Once more, we refer to the 2014 independent industry report, "A Vision for Real Estate Finance in the UK" (available, along with associated materials, here: https://www.crefceurope.org/committee/9). That report considered precisely the question of how financial stability could best be protected from the property cycle, while the trauma of the GFC was very fresh. Recommendation 4 of the *Vision* report argued for the development of robust, long-term measures of property values that would be insensitive to the investment cycle. Long-term property value metrics would provide a lens through which the cyclical risk associated with any particular level of market value-based LTV could be understood, making it easier for market participants to manage risk responsibly. The report recommended that the incentive structure for banks be further strengthened by linking regulatory capital to long-term value metrics, once they had gained the confidence of regulators and market participants. It should be possible to establish guidelines to help lenders and borrowers minimise the risks associated with excessive leverage without the use of crude LTV caps.

In the absence of that kind of mechanism, it would be better to set a leverage limit that (a) is tested only at loan inception, (b) does not apply to pre-existing funds and loans already in place, and (c) is set at a level likely to allow the relevant financing to survive cyclical price shocks and overheating (and so that does not rely on the CBI adjusting the limit when it is triggered to avoid widespread forced sales).

QQ7-9 *relate to the liquidity management proposals, so are omitted from this document.*

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?

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),
- Undermine the ability of, and incentives for, market participants to manage property cycle risk and leverage responsibly themselves, and
- Do nothing to deliver on the CBI's stated policy objective of safeguarding 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.

For those reasons, as mentioned above, if a regulatory leverage limit is to be taken forward at all, we would prefer that it: (a) is tested only at loan inception, (b) does not apply to pre-existing funds and loans, and (c) is set at a level, and structured in a way, likely to allow most financings to survive cyclical price shocks and overheating (and so that does not rely on the CBI's ability to adjust the limit when it is triggered for avoiding widespread forced sales). That level should be at least 65% LTV; and the structure of the leverage limit should be such that after a breach a period of at least two years follows, during which action might be taken to cure the breach, or market values might recover from temporary stress.

Q11 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.

All discussed above.

***Q12** relates to the liquidity management proposals, so is omitted from this document.*

Q13 If you have any further thoughts or considerations on the proposals outlined in Consultation Paper 145, please share them below.

While this is a relatively marginal point in the scheme of things, we should mention that we are not convinced that the CBI has the legal authority on which it claims to rely for the inclusion of shareholder debt in the proposed leverage limit.

As a practical matter, this only matters for certain existing funds, as the use of shareholder debt is no longer permitted for new funds; and it will not matter at all if the CBI is persuaded to exclude existing funds and loans from the scope of the proposed measure. However, the point is in our view worth making because, as explained in earlier responses, the measure as proposed would have a very prejudicial impact on any funds that are affected by the inclusion of shareholder debt, as well as the providers of third party debt to such funds.

On p16 of CP145, the CBI identifies the legal basis of its power to impose leverage limits in line with macroprudential needs as arising under the Irish transposition of Article 25 AIFMD. That allows the CBI to impose limits on leverage "*to limit the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system or risks of disorderly markets*". The use of shareholder debt may be objectionable for other reasons, but we are not aware of any reason to imagine, and the CBI has offered no evidence to suggest, that it "*contributes to the build-up of systemic risk in the financial system or risks of disorderly markets*". Unless there is such evidence, we would argue that the inclusion of shareholder debt in the proposed leverage limit may be ultra vires.

We would in any event question the policy justification for including shareholder debt (which is economically equivalent to equity) within the proposed leverage limit. CP145 suggests that doing so "minimises the possibility for regulatory arbitrage", but no evidence is provided to suggest that use is made in the real world of "options for increasing leverage via unregulated affiliated entities". Historically, there have been tax benefits associated with structuring equity investments as debt (as well as commercial benefits relating most obviously to the greater ease of profit extraction); but those tax benefits have already been largely removed by successive policy interventions over recent years. In what other sense does shareholder debt "increase leverage", to what end, and with what adverse macroprudential implications? The CBI has not made a clear or compelling case for including equity investments structured as shareholder debt within the scope of the proposed measure.