WILLIAM FRY

// ASSET MANAGEMENT & INVESTMENT FUNDS

Central Bank consults on macroprudential measures for property funds

December 2021

On 25 November 2021, the Central Bank published a consultation paper on the introduction of measures designed to address financial stability concerns arising out of identified liquidity mismatch and excessive levels of leverage in property funds, including:

1. a 50% loan-to-value leverage limit for Central Bank-authorised qualifying investor alternative investment funds (**QIAIF**) investing over 50% directly or indirectly in Irish property assets (**Property Funds**). All loans, including affiliated and shareholder loans, would be included in the on-balance sheet leverage limit which would be applied by way of Central Bank notice under the Irish AIFM Regulations to Property Funds reporting leverage levels close to or above the 50% limit and, as such, all Property Funds would, de facto, be subject to the limit. Existing Property Funds would have a three-year transition period from finalisation of the leverage limit to arrange for compliance; and

2. liquidity timeframe guidance for Property Funds, including an expected minimum 12-month period from redemption deadline to settlement date for Property Funds structured as open-ended with limited liquidity. The guidance would apply to new Property Funds from authorisation and existing Property Funds would be expected to make any necessary changes to take account of the guidance at the earliest opportunity.

Background

As previously highlighted (here), the Central Bank, along with other regulators, legislators and standards setters, has increasingly focussed on the necessity for a macroprudential framework for funds. Following its 2020 deep-dive survey of the Property Fund sector (**Deep Dive Survey**) (discussed here and below), the Central Bank identified financial stability issues arising out of the sector's elevated exposure to Irish property assets and financial vulnerabilities in the form of liquidity mismatches and high levels of fund leverage.

Liquidity Mismatch

The Central Bank considers liquidity mismatch in funds (i.e., where a fund's dealing frequency does not match the liquidity of the underlying assets) a potential source of financial vulnerability as it can force funds, in receipt of large redemption requests which may not be met out of liquid assets, to sell assets in a short period of time thus leading to dislocated prices and knock-on real economy effects.

Liquidity timeframes (i.e., time from redemption request deadline to redemption settlement date) of Property Funds ranges from 7 to over 1200 days, with 58% of funds (accounting for €13.6bn approx. of property assets) having timeframes of less than 200 days. Fund managers responding to the Deep Dive Survey estimated an average of 180-213 days to sell a property in normal economic times and 420 days in stressed economic times. The Central Bank is concerned, therefore, as to the *"significant liquidity mismatches in the majority of the funds surveyed"* estimating that, on the basis of the survey results, only 17% of property assets are held in funds which would avoid liquidity mismatches during stressed market conditions by having a liquidity timeframe of 400 days of more.

The Central Bank notes that liquidity mismatch risk in Property Funds can be mitigated by factors such as the level of liquid asset holdings (generally 5% of assets), infrequent dealing (most are closed-ended or limited liquidity funds) and a limited investor base (65% of property assets are held in single-investor funds). However, it remains concerned as to the surveyed funds' ability to deal with large redemption requests as the results highlight that the majority of Property Funds operate liquidity timeframes of less than 200 days. And while single-investor funds may not, due to the absence of first-mover advantage dynamics, be as susceptible to liquidity mismatch risks, the Central Bank is concerned as to the possibility of indirect liquidity mismatch risk given approximately one-fifth of such funds are financial institutions with multiple underlying investors.

Elevated levels of leverage

The Central Bank considers higher levels of leverage in Property Funds to be problematic as it can have an amplifying effect on decreasing equity returns in downward markets and, in its Deep Dive Survey results, pointed to several sources concluding that overall leverage has a negative impact on Property Fund returns.

The Deep Dive Survey found that a significant portion of funds (67% of single-investor and 41% of multi-investor) have leverage levels of more than 50%. While such levels are higher than the European average, the Central Bank acknowledges this is, in part, due to the significant presence of shareholder and affiliated lending in Irish Property Funds. However, even when affiliated loans are excluded from the leverage metrics, Irish Property Funds hold higher leverage than their European counterparts. And while most of the funds surveyed have a single investor, the Central Bank does not view this as necessarily affecting the increased vulnerability of being highly leveraged as a single investor may still look to sell fund assets, whether as result of being leveraged in its own right or otherwise, during stressed market conditions and thereby triggering downward price pressures.

The Central Bank has identified a cohort of Property Funds that have both liquidity mismatch and higher leverage. In total, 35 Property Funds, representing €5.2bn of property assets (or around 1.3 times the 2014-2019 average annual CRE investment transaction volume) both have liquidity timeframes of less than 180 days and have leverage greater than 50%. These funds are considered to be "*particularly vulnerable to an external shock or sudden economic downturn."*

Next Steps

The consultation on the financial stability measures at 1 and 2 above is open until 18 February 2022 and the Central Bank requests that respondents provide reasons for responses given and that suggested changes are supported, where possible, by evidence which will support Central Bank consideration of issues raised. The Central Bank intends to provide feedback following the close of the consultation period but no timeframe for the feedback or publication of finalised measures has yet been indicated.