INREV response to ESMA consultation on AIFMD Article 25 Guidelines on assessment of leverage in funds

28 August 2020

INREV* is pleased to have the opportunity to make a few brief comments on the consultation paper on Guidelines on Article 25 of Directive 2011/61/EU.

INREV strongly supports the use of consistent methodology to compute leverage across Member States in order to collect data to identify potential sources of risk to financial stability and that for the purpose of calculating leverage limits, NCAs should consider the leverage measures set out in the AIFMD framework.

To help understand current use of leverage in real estate funds compared with historical levels, we have provided some additional information from INREV databases below the responses to the specific questions asked. The data tables reflect a time series of both average actual and target leverage for all real estate funds in our database, which is further broken down by open end and closed end funds, showing low leverage style ('core') funds (leverage ≤ 40%), medium leverage ('value added') funds (leverage > 40% but ≤ 60%) and high leverage ('opportunistic') funds (leverage > 60%). There are also data in a historical time series showing the number of funds and GAV for all real estate funds, which is also broken down into open end and closed end funds. These last charts enable insight into market share and therefore weighted actual and average permissible leverage levels in open end and closed end funds from 2007 through the first quarter of 2020.

In short, the data show that leverage overall is significantly down from the levels seen around the global financial crisis and that there is now much more headroom between the actual and allowable levels of leverage in funds, which points to much less systemic risk. The core, low leverage open end funds as well as the value added, moderate leverage funds are significantly larger and more numerous than opportunistic funds, and therefore the bulk of real estate fund investment is in lower leverage funds.

INREV has to our knowledge the largest database of this kind of fund data and we estimate that our data cover approximately 80% of all non-listed institutional real estate funds in Europe. These funds are not open to investment for retail investors.

Data provided in the charts below are a subset of INREV Quarterly Index and have following features:

- Institutional funds with more than 2 investors investing in European real estate.
- Only core and value added funds
- Minimum threshold to show data are at least 3 funds from 3 different investment managers
- INREV Index has a bigger exposure to core, open end funds, as a result, the breakdowns provided are represented by a larger share/size of open end funds
- All data points as of Q1 of each year

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Real Estate funds - permitted vs actual leverage by style, for all, open end and closed end funds

All funds

Permitted LTV bracket	Actual / target gearing	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
≤ 40%	Actual fund gearing	8,7%	12,9%	15,1%	14,2%	11,3%	13,8%	13,6%	13,9%	11,5%	10,4%	11,7%	11,7%	12,7%	13,2%
	Average fund target gearing	18,2%	17,1%	18,0%	17,0%	15,9%	17,3%	17,3%	17,1%	17,0%	18,4%	18,9%	19,8%	19,6%	19,3%
> 40% - ≤ 60%	Actual fund gearing	34,8%	40,1%	44,6%	43,5%	40,9%	40,3%	40,5%	38,2%	34,4%	31,3%	33,0%	31,4%	30,6%	30,8%
	Average fund target gearing	46,7%	47,2%	47,5%	47,0%	47,1%	47,0%	47,3%	47,0%	47,6%	47,6%	46,9%	46,5%	46,2%	45,7%
> 60%	Actual fund gearing	56,7%	56,8%	60,9%	62,5%	59,2%	57,3%	55,4%	52,1%	45,8%	41,3%	38,0%	32,2%	34,1%	37,0%
	Average fund target gearing	59,5%	62,2%	63,3%	60,9%	60,8%	61,9%	63,4%	63,4%	63,6%	63,4%	63,3%	62,5%	61,4%	58,8%

Open end funds

Permitted LTV bracket	Actual / target gearing	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
≤ 40%	Actual fund gearing	10,8%	14,8%	17,2%	16,1%	12,6%	15,4%	15,2%	15,0%	12,5%	11,1%	12,2%	11,9%	12,7%	13,2%
	Average fund target gearing	19,8%	18,1%	18,4%	17,6%	16,2%	17,3%	16,8%	16,2%	16,4%	17,0%	17,7%	18,8%	18,6%	18,6%
> 40% - ≤ 60%	Actual fund gearing	27,8%	34,8%	39,5%	38,5%	36,1%	35,7%	34,8%	31,8%	31,4%	29,0%	31,0%	29,7%	28,8%	29,5%
	Average fund target gearing	42,0%	42,9%	42,1%	42,6%	42,9%	42,8%	42,8%	42,6%	43,9%	44,6%	44,4%	44,7%	44,5%	44,4%
> 60%	Actual fund gearing	35,0%	46,3%	53,9%	53,6%	51,9%	50,6%	48,5%	44,5%	39,7%	34,1%	36,2%	31,7%	33,1%	34,2%
	Average fund target gearing	45,0%	45,0%	45,0%	50,6%	50,6%	55,0%	54,3%	51,7%	51,7%	51,7%	51,7%	50,0%	50,0%	50,0%

Closed end funds

Permitted LTV bracket	Actual / target gearing	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
≤ 40%	Actual fund gearing	3,3%	7,2%	8,0%	6,6%	5,1%	4,8%	5,0%	7,7%	5,5%	5,8%	8,3%	10,0%	12,2%	12,9%
	Average fund target gearing	12,0%	12,0%	16,6%	14,8%	14,8%	17,3%	19,4%	20,2%	18,9%	22,4%	22,1%	22,4%	23,0%	22,1%
> 40% - ≤ 60%	Actual fund gearing	38,9%	44,0%	48,2%	47,8%	45,1%	45,2%	46,8%	46,7%	38,8%	35,1%	36,9%	35,2%	35,1%	35,9%
	Average fund target gearing	53,3%	53,8%	54,1%	52,0%	51,2%	51,1%	51,7%	51,7%	51,7%	51,3%	50,2%	49,2%	49,0%	48,3%
> 60%	Actual fund gearing	62,1%	59,6%	62,0%	64,4%	60,8%	59,3%	57,2%	53,8%	47,6%	44,4%	38,8%	32,6%	34,9%	43,2%
	Average fund target gearing	64,1%	65,4%	65,8%	62,6%	62,5%	63,1%	64,5%	64,7%	65,1%	65,1%	65,1%	64,6%	63,5%	61,1%

Real Estate funds permitted vs actual leverage by style, for all, open end and closed end funds indicating number of funds and GAV

All funds

Permitted LTV bracket	Actual / target gearing	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
≤ 40%	Number of funds	25	29	33	40	46	50	54	62	64	64	67	67	65	61
	GAV (€ billion)	27,2	26,6	22,8	29,5	35,6	42,4	43,4	47,5	52,8	62,4	66,7	74,6	84,6	90,9
> 40% - ≤ 60%	Number of funds	58	71	88	120	132	141	144	146	151	146	141	133	129	111
	GAV (€ billion)	22,1	33,6	40,2	54,8	61,9	59,5	57,7	55,7	58,0	60,0	61,8	69,4	76,9	77,3
> 60%	Number of funds	21	32	42	63	62	62	63	59	56	47	44	35	32	24
	GAV (€ billion)	9,0	16,1	16,7	25,2	25,3	26,8	24,5	19,1	16,7	14,5	11,3	8,5	7,4	6,7

Open end funds

Permitted LTV bracket	Actual / target gearing	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
≤ 40%	Number of funds	20	24	25	31	37	40	43	48	49	48	49	49	50	49
	GAV (€ billion)	19,2	19,8	17,0	22,8	28,3	34,7	35,6	39,3	43,5	52,2	56,8	65,1	75,0	82,8
> 40% - ≤ 60%	Number of funds	34	43	48	64	65	71	72	76	79	80	79	81	80	75
	GAV (€ billion)	5,2	11,6	15,1	23,6	27,0	29,1	28,5	30,0	33,1	36,0	39,3	48,7	55,6	62,6
> 60%	Number of funds	5	5	5	9	9	9	7	6	6	6	6	5	5	5
	GAV (€ billion)	2,0	3,6	2,5	4,8	4,9	6,4	5,4	3,8	4,0	4,7	4,4	4,1	4,2	5,1

Closed end funds

Permitted LTV bracket	Actual / target gearing	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
≤ 40%	Number of funds	5	5	8	9	9	10	11	14	15	16	18	18	15	12
	GAV (€ billion)	8,0	6,8	5,8	6,7	7,3	7,7	7,8	8,2	9,3	10,2	9,9	9,4	9,6	8,1
> 40% - ≤ 60%	Number of funds	24	28	40	56	67	70	72	70	72	66	62	52	49	36
	GAV (€ billion)	16,9	22,0	25,1	31,2	34,9	30,4	29,2	25,6	25,0	24,0	22,5	20,7	21,3	14,7
> 60%	Number of funds	16	27	37	54	53	53	56	53	50	41	38	30	27	19
	GAV (€ billion)	7,0	12,5	14,2	20,3	20,4	20,4	19,1	15,2	12,7	9,8	6,9	4,3	3,2	1,6

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Q1. What are your views on the frequency at which the risk assessments should be performed by NCAs?

We agree that requiring NCAs to perform risk assessments on a quarterly basis as proposed is frequent enough for NCAs to assess the leverage-related systemic risk.

Q2. What are your views on the sample of funds to be included under Step 1? Do you agree in including in the risk assessment not only substantially leveraged funds but also funds not employing leverage on a substantial basis which may pose financial stability risks?

We agree with including funds in Step 1 that employ leverage on a substantial basis as well as non-substantially leveraged AIFs that may cause risks to financial stability, and therefore can be assessed in Step 2. However, the criteria for determining how funds that do not employ leverage on a substantial basis, but may pose financial stability risks should be clearly defined.

Q3. Do you agree with the proposed threshold identified under Step 1? Would you set the same threshold for all AIFs, or would you be in favour of setting different thresholds based for different types of AIFs (e.g.: real estate, hedge funds, private equity etc) or sub-types of AIFs (please specify) based on a statistical analysis (e.g. percentile)? Should you prefer the latter option, please provide proposals and detailed arguments and justification supporting them.

Real estate funds tend to be very large due to the size of the assets held. The EUR 500 million Step 1 threshold for AIFs that employ leverage but not on a substantial basis would therefore include the vast majority of real estate funds, even though most real estate funds use very modest levels of leverage. A different threshold for real estate funds based on a statistical analysis such as a percentile or standard deviation from the mean, a higher AUM threshold or a leverage-to-value threshold would allow the NCAs to concentrate on funds that are considered to pose more potential risk.

Q4. Would you identify other relevant transmission channels?

No.

Q5. What are your views on using not only leverage indicators, but also other types of indicator such as those indicated under Table 2 of the draft Guidelines? Do you agree with the list of indicators provided?

We do not take a position on the use of the other indicators listed under Table 2 but agree that the risk assessment should be consistent across jurisdictions and based on a common methodology and indicators..

Q6. What are your views on using not only AIFMD data but also other external data sources to perform the assessment? Which types of external data sources would you consider more useful

for the purpose of performing the assessment under Step 2, other than those already identified in Annex of to the draft Guidelines?

We do not take a position on the use of other external data sources to perform the assessment under Step 2 other than those identified in the Annex.

Q7. Which other restrictions would you consider as appropriate?

We agree with the point raised by the ESRB, that in order to address liquidity mismatches for open end funds, managers could implement redemption policies and reduce the frequency of redemptions offered, or impose notice periods for investors wishing to redeem from an investment fund.

Q8. What are your views on the application of the leverage limits? Should those be applied only on the single fund or, where appropriate, limits should also be applied on group of funds? In this case, how would you identify the group of funds?

We do not take a position on whether, where appropriate, limits should be applied on groups of funds in addition to single funds.

Q9. How would you assess the efficiency of leverage limits in mitigating excessive leverage?

The use of leverage limits could be an effective and efficient tool for mitigating excessive leverage that could cause systemic risk for the financial sector.

* INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. We provide guidance, research and information related to the development and harmonisation of professional standards, reporting guidelines and corporate governance within the non-listed property funds industry across Europe.

INREV currently has 458 members. Our member base includes institutional investors from around the globe including pension funds, insurance companies and sovereign wealth funds, as well as investment banks, fund managers, fund of funds managers and advisors representing all facets of investing into non-listed real estate vehicles in the UK and the rest of Europe. Our fund manager members manage more than 500 non-listed real estate investment funds, as well as joint ventures, club deals and separate accounts for institutional investors.