Monetary Authority of Singapore

# Borrowing Guidelines for Property Funds

Consultation Paper

16 December 2002

# INTRODUCTION

Property funds are regulated as collective investment schemes under Part XIII of the Securities and Futures Act. Like general securities funds, property funds are required to comply with a prudential borrowing limit so that unitholders are not subject to undue risk. The rationale is that the fund should be able to service its debt and not be forced to liquidate its assets, especially at the bottom of property market cycles, to the detriment of unitholders.

2 The Property Fund Guidelines currently limit borrowings in a property fund to 25% of the fund's deposited property. Unlike borrowings of general securities funds which are limited to 10% and may only be used for the purposes of meeting redemptions and short-term bridging requirements, borrowings by a property fund can be used for investment purposes.

3 This consultation paper seeks comments from the industry and public on the proposal to raise the borrowing limit for property funds. The proposal is part of the Authority's ongoing review of its regulations to facilitate offers of investments without compromising investor protection. We have also considered feedback from the industry and recommendations from the ERC Land Working Group to raise the borrowing limit for property funds to 35%.

4 The proposals in this paper aim to give property funds more room in determining their debt-equity ratios while continuing to retain safeguards such that the fund can service and repay its debt.

5 Please send your comments by <u>16 January 2003</u> to:

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# PROPOSED BORROWING GUIDELINES

6 As recommended by the ERC Land Working Group, the borrowing limit for property funds will be raised to 35% of the fund's deposited property.

7 A property fund may borrow more than 35% of the fund's deposited property only if:

(a) the total borrowings in the property fund are made via debt issues[1] which are rated at least A (including any sub-categories or gradations therein) by Fitch Inc., Moody's or Standard and Poor's at the time of borrowing; or

(b) the property fund itself is rated at least A (including any sub-categories or gradations therein) by Fitch Inc., Moody's or Standard and Poor's at the time of borrowing.

*The borrowing limit of 35% is a basic cap which property funds have to comply with and is known to investors of property funds upfront. However, the Authority accepts that there may be cases in which a property fund is able to support higher levels of borrowing without incurring undue risk. A credit rating assigned by an independent credit rating agency serves as a proxy for gauging the fund's ability to service and repay all its debt where the fund wishes to borrow beyond 35%.*

8 If the above ratings subsequently fall below A due to property market conditions which lead to a fall in property values or income, no corrective action need be taken, but the property fund should not incur additional borrowings. Furthermore, the property fund should not change the composition of its properties after the borrowings are incurred if doing so would result in a downgrade of the ratings.

9 Where the requisite A rating is proposed to be obtained through a credit enhancement (e.g. a guarantee), MAS should be consulted in advance.

[1] Bonds, syndicated loans or other debt may be issued, directly by the fund or indirectly via a special purpose vehicle.

# ENHANCED DISCLOSURE

10 In addition, the Authority is considering enhancing the disclosure of risks specific to investing in property funds. Such disclosure would cover the following:

(a) *Diversification* – Property funds tend to be less well-diversified than general securities funds.

(b) *High gearing* – Property funds tend to be more highly geared than general securities funds. This could be risky if interest rates rise sharply.

(c) *Pricing of properties* – Property valuation, which determines the offer price of units in a property fund, is subjective.

(d) *Illiquidity of properties* – The underlying properties in a property fund are often illiquid. This may impact the ability of a property fund to make distributions to unitholders where market conditions fall.

# REQUEST FOR COMMENTS

11 You are invited to comment on:

(a) the proposals in this paper to
- raise the borrowing limit for property funds to 35% of the fund's deposited property; and
- allow borrowings exceeding 35% of the fund's deposited property if certain rating requirements are met;

(b) any practical implementation issues arising from the proposal, such as
- those which relate to the calculation of a property fund's borrowing level i.e. the factors which ought to be considered in determining the numerator and denominator (e.g. whether we should distinguish between differences in the intended use of borrowings such as purchasing properties, refurbishing properties, short-term financing, etc.; whether we should use the value of new properties *intended* to be purchased with the proposed borrowing or the value of properties owned by the fund immediately before new borrowing is incurred); and
- the consequences of using debt ratings versus fund ratings as an appropriate proxy for gauging a property fund's ability to service and repay all its debt,

and suggested ways of dealing with those issues;

(c) the content and form of appropriate risk disclosures associated with investing in property funds; and

(d) whether the proposals provide adequate safeguards to investors that the property fund is able to service and repay its debt.