



26 November 2021

Central Bank publishes consultation paper on Irish domiciled property funds

Background

As readers may be aware, the Central Bank of Ireland (**Central Bank**) has recently been examining the Irish property fund sector in close detail with a particular focus on leverage and liquidity mis-match as two potential sources of financial vulnerability.

On 25 November 2021, the Central Bank published a [consultation paper \(Consultation Paper\)](#) in which it outlined proposals to impose certain leverage limits on Irish domiciled funds which invest over 50% directly or indirectly in Irish property assets (**In-Scope Funds**). The Consultation Paper also proposes that In-Scope Funds should also comply with additional guidance to limit liquidity mismatch. The Central Bank explains in the Consultation Paper that it believes that the proposed measures are necessary in order to increase the resilience of such funds to ensure that they can absorb rather than amplify any future adverse shocks in the Irish commercial real estate (**CRE**) market.

Leverage Measures

The Central Bank has identified a specific cohort of In-Scope Funds with what it considers to be elevated levels of leverage and has specific concerns as to the impact on financial stability should such In-Scope Funds be unable to service their CRE loans and be required to sell off significant portions of their portfolios in a short period of time. It notes the risks this poses to the ability of banks to continue to provide finance to the economy, the operation of the construction sector and the wider real economy.

Leverage Limits

In light of these concerns, the Central Bank is consulting on a proposed 50% leverage limit for all In-Scope Funds to be determined by the ratio of total assets to total liabilities (or its equivalent applying the AIFMD gross or commitment methodologies). The Central Bank is proposing the imposition of the

Key Points to Note:

- Proposals will apply to Irish domiciled funds which invest over 50% directly or indirectly in Irish property assets
- Proposals include:
 - Leverage limits being imposed on In-Scope funds; and
 - Guidance on how liquidity mismatches should be managed
- Existing In-Scope Funds will have 3 years within which to comply with new leverage limits

leverage limit through the existing AIFMD legislative framework¹ and in line with the related ESMA Guidelines².

Review of Leverage generated by In-Scope Funds

In practice, the Central Bank is proposing that it will review the use of leverage by In-Scope Funds as part of its annual review of funds and based on the information contained in the regular reporting it receives with respect to such funds. Where, in the course of that review, the Central Bank identifies In-Scope Funds with levels of leverage close to, or above the 50% limit, such funds will be issued with notices confirming the application of a specific binding leverage limit. The Consultation notes that there may be a number of different metrics applied to the fund specific limit based on those outlined in the ESMA Guidelines and further consideration of how those metrics are calculated and applied will be required. It is worth noting that the Central Bank considers that the leverage limit applies de facto to all In-scope Funds. Even if an In-Scope Fund with a low level of leverage is not subject to notification of a specific binding leverage limit in any given year, if it breaches the leverage limit, it will be issued with a specific binding leverage limit the following year.

Transition Period for Existing In-Scope Funds

The Central Bank has acknowledged that existing In-Scope Funds with leverage levels in excess of the leverage limit will need to time to comply in order to ensure the reduction of leverage is effected in an orderly manner.

Accordingly the Central Bank is proposing a three year transition period and has indicated that In-Scope Funds will be allowed formulate their own plan for reducing leverage. The Central Bank has indicated that it is proposed that In-Scope Funds with leverage limits in excess of 50% will be subject to an assessment in line with Regulation 26 of the AIFM Regulations at a particular point in time post the consultation period and the Central Bank will thereafter communicate directly with such funds to put in place the required reduction plan. It has also indicated that it may impose individual interim limits (on a path towards the 50% limit) during the transition period. Presumably this is intended to ensure a gradual and targeted unwind of leverage levels in a way that will ensure the 50% leverage limit is met within the required three year timeframe but also to limit the possibility of large scale sell offs towards the end of the transition period.

Application of Leverage Limits on Newly Established In-Scope Funds

The Central Bank will seek to impose this leverage limit on all new In-Scope funds at the time of authorisation and such funds will be subject to the annual assessment commencing in the year following their first annual reporting date.

¹ Article 25 of AIFMD, transposed into Irish law via Regulation 26 of the European Union (Alternative Fund Managers) Regulation 2013 as amended, provides the Central Bank with the power to impose limits on the level of leverage employed by an AIFM with respect to an AIF in order to limit the extent to which the use of leverage contributes to systemic risk in the financial system or risks of disorderly markets.

² https://www.esma.europa.eu/sites/default/files/library/esma34-32-701_guidelines_on_article_25_aifmd.pdf
10566682v1

Review of Leverage Limit imposed by the Central Bank

Finally, it is worth noting that the Central Bank intends to keep the leverage limit under review to ensure they are achieving the stated aims and are not otherwise causing “undue burden” on participants in the Irish CRE sector. The Central Bank confirms that it will look to take appropriate action by either increasing or decreasing the leverage limits should market circumstances require.

Guidance on Liquidity Mismatch

The draft guidance on redemption terms for In-Scope Funds (**Draft Guidelines**) would appear to have been informed by the Central Bank’s Property Fund “deep dive” survey which was conducted in Q1 2020. In keeping with the Central Bank’s long established principle of alignment of the liquidity profile of the relevant AIF and the redemption cycle, the Central Bank has again stressed the importance of considering the liquid nature of the assets to avoid a potential liquidity mismatch.

The Draft Guidelines will require AIFMs of In-Scope Property Funds to consider the liquidity profile of the assets in both normal and stressed market conditions when determining the redemption terms. Consideration should be given to the retention of a cash buffer where appropriate though the Central Bank indicates that over-reliance on such buffer could be prejudicial to investors who submit redemption requests at later redemption dates.

To date, the Central Bank has authorised property funds as either closed-ended funds or open ended funds with limited liquidity. Under the Draft Guidelines, where an In-Scope Property Fund is formulated as an open- ended fund with limited liquidity, the Central Bank has suggested a liquidity timeframe of at least 12 months which it believes should assist in ensuring that the redemption terms, including notice periods and settlement periods, of the In-Scope Property Fund align with the liquidity of the assets held in both normal and exceptional circumstances. This timeframe would appear to align with the annual dealing cycles of many current products in the market. The Central Bank notes that such a proposal would potentially impact 48 property funds (less than 33% of the authorised number of property funds) which would be required to elongate their notice and settlement period to ensure alignment of the liquidity and redemption cycles.

Notably, though the Central Bank has suggested a minimum liquidity cycle of 12 months, it has not ruled out the potential for more frequent dealing. Where an In-Scope Fund has or intends to have shorter liquidity timeframes, the AIFM must be able to demonstrate with sufficient evidence (including from periods of stressed market conditions where liquidity may be strained due to the collective selling activity) that the fund could sell its assets with no material impact on market prices over that shorter timeframe.

The Central Bank proposes that existing In-Scope Funds should make any necessary changes to their structure and fund documentation to incorporate the provisions of the guidance “*at the earliest possible opportunity*”. New In-Scope Funds would be expected to comply with the Draft Guidelines from the date of authorisation.

Next Steps

The Central Bank has sought feedback on its proposals no later than 18 February 2022 and has indicated that any submissions that suggest changes to the proposals made by the Central Bank should be supported, where possible, by evidence.

If you would like to feed into Dillon Eustace's response to the Central Bank on the Consultation Paper or if you have any questions in relation this briefing, please contact any of the authors or your usual contact in Dillon Eustace.

Dillon Eustace LLP November 2021



Etain de Valera

DD: + 353 1 673 1739

etain.devalera@dilloneustace.ie



Shane Coveney

DD: + 353 1 673 1749

Shane.Coveney@dilloneustace.ie

DILLON EUSTACE

Dublin

33 Sir John Rogerson's Quay, Dublin 2, Ireland. Tel: +353 1 667 0022

Cayman Islands

Landmark Square, West Bay Road, PO Box 775, Grand Cayman KY1-9006, Cayman Islands. Tel: +1 345 949 0022

New York

Tower 49, 12 East 49th Street, New York, NY10017, U.S.A. Tel: +1 646 770 6080

Tokyo

12th Floor, Yurakucho Itocia Building, 2-7-1 Yurakucho, Chiyoda-ku, Tokyo 100-0006, Japan. Tel: +813 6860 4885

DISCLAIMER

This document is for information purposes only and does not purport to represent legal advice. If you have any queries or would like further information relating to any of the above matters, please refer to the contacts above or your usual contact in Dillon Eustace LLP.

Copyright Notice:© 2021 Dillon Eustace LLP. All rights reserved.