November 2022

Central Bank issues finalised guidance on Leverage in Irish authorised Funds investing in Irish Real Estate

As set out in our last bulletin, we set out how 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.

The Central Bank has now finalised and published on its website its guidance on leverage and liquidity in Irish authorised funds investing in Irish Real Estate (the **Guidance**).

Entities In Scope of the Guidance

The Guidance is relevant to Alternative Investment Funds (**AIFs**) domiciled in Ireland, authorised under domestic legislation, and investing fifty per cent or more directly or indirectly in Irish property assets, hereafter termed "**Property Funds**". It is supplementary to the provisions of the Central Bank's AIF rulebook. Non-Irish alternative investment fund managers (**AIFMs**) should note that the Guidance will apply to them where they act as AIFM of Property Funds.

The Central Bank's Feedback Statement on its consultation, issued with the Guidance clarifies that in calculating the fifty per cent exposure, 'directly held assets' refers to on-balance sheet holdings of real estate. The Central Bank also provides a non-exhaustive list of mechanisms used to achieve indirect exposure including use of a special purpose entity (**SPE**) or similar vehicles; partnership arrangements; or investment in other funds that hold Irish property assets. Indirect exposure to real estate through equities, debt instruments and certain exchange traded derivatives are not included in the fifty per cent calculation.

For further information on any of the issues discussed in this article please contact:

Derbhil O'Riordan
DD: + 353 1 673 1755
derbhil.oriordan@dilloneustace.ie

Shane Coveney
DD: + 353 1 673 1749
shane.coveney@dilloneustace.ie

Guidance on Leverage in Property Funds

The finalised Guidance[1] includes the following changes for operation of leverage in Property Funds:

(a) For newly established Property Funds, an on-balance sheet leverage limit of sixty per cent total debt-to-total assets (**Leverage Limit**) will be imposed by way of condition of authorisation;

(b) For existing Property Funds, the Leverage Limit will be subject to a five year implementation period, which will last until 24 November 2027;

(c) For social housing funds investing at least eighty per cent of AuM in social housing, the Leverage Limit will not apply provided that the social housing fund:

  (i) clearly states in its prospectus that it has an investment objective of investing in social housing;

  (ii) holds long-term leases;

  (iii) income is guaranteed and paid by the local authority for the period of the lease irrespective of occupation; and

  (iv) debt has no LTV covenants or repayment-on-demand covenants;

(d) For Property Funds pursuing development activity, a different methodological framework for the purpose of calculating leverage on those specific assets may be used.

AIFMs calculating the Leverage Limit will note that the Central Bank has clarified that the calculation of on-balance sheet leverage must be based on one of the four prescribed definitions of leverage as set out in the AIFMD, all of which relate to current leverage (rather than leverage at loan origination), and all of which are calculated using market-based valuations.

The Central Bank has stated that the five-year implementation period for Property Funds which have been authorised prior to 24 November 2022, should be implemented with gradual and steady progress. It has also stressed that forced asset sales run contrary to the underlying objective of the Leverage Limit itself.

The final Guidance differs from the initial consultation paper on the topic issued by the Central Bank, having increased the leverage limit from the previously suggested 50% ratio of total assets to total liabilities, exempting social housing investment funds from the leverage limit requirements and providing a longer implementation period for Property Funds to comply with the Guidelines.

[1] Endorsed by ESMA in its paper published on 23 November 2022: https://www.esma.europa.eu/sites/default/files/library/esma50-164-6745_esma_advice_on_cbi_measure_aifmd_art25.pdf

Guidance on Liquidity in Property Funds

In order to further mitigate vulnerabilities stemming from liquidity mismatch in property funds, the Central Bank has confirmed that it will not authorise Property Funds if they are not structured as (i) closed-ended or (ii) open-ended with limited liquidity as per the Central Bank's AIF Rulebook. This position reflects current practice in the market for Property Funds.

The Central Bank provides additional Guidance for AIFMs of Property Fund designing redemption terms, such that AIFMs must take into account the liquidity of property assets under both normal and stressed market conditions so that Property Funds should have liquidity timeframes with a minimum of at least 12 months.

For Property Funds which have been authorised prior to 24 November 2022, the Central Bank is providing an eighteen month implementation period running until 24 April 2024 in relation to the minimum liquidity timeframe.

Overall, the guidance represents a slight relaxation of the proposed leverage limit and implementation period that was contemplated in the Central Bank's consultation paper 145. Certain matters, will need to be explored further with the Central Bank, who are hosting a Q&A on the Guidance on 2 December 2022 at which we will be present. Further updates may follow after that meeting.

If you would like to discuss any of the topics covered above and how they will impact your existing or planned Property Funds please reach out to Derbhil O'Riordan, Shane Coveney or your usual contact at Dillon Eustace.

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
33 Irving Place, New York, NY10003, 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