
# Ireland Update – Central Bank's property fund proposals

December 2021

On 25 November 2021, the Central Bank of Ireland (the "Central Bank") published a consultation paper, CP145, entitled "Macroprudential measures for the property fund sector" (the "Consultation Paper"). The Central Bank is consulting on two key proposals: (i) a proposal to introduce leverage limits on certain property funds; and (ii) proposed guidance relating to liquidity mismatches. It is intended that these proposals will apply to alternative investment funds ("AIFs") domiciled in Ireland, authorised under domestic legislation and investing over 50% directly or indirectly in Irish property assets[1] (each a "Property Fund"). The Central Bank is seeking feedback on the proposals set out in the Consultation Paper by 18 February 2022.

## Background to the proposals

In recent years, the Central Bank has increased its focus on the property fund sector as the participation of such funds in the Irish commercial real estate ("CRE") market has continued to grow. In the Consultation Paper, the Central Bank notes over the past five years, property funds' Irish property asset portfolios are estimated to have increased by around €12 billion. The Consultation Paper also states that as of the end of 2020, property funds accounted for over 40% of the estimated stock of "investable" real estate in Ireland. Such increased participation in the CRE market has benefits for both macroeconomic and financial stability through increased diversification of funding sources however the Central Bank notes that there are two potential sources of financial vulnerability that could affect the resilience of this form of financing in future periods of stress.

In December 2019, Governor Makhlouf advised that he asked his colleagues in the Central Bank to conduct a deep dive on property funds and assess: (i) the resilience of this growing form of market-based finance to the domestic economy; and (ii) whether there was a need for a macroprudential response to any potential risks identified. A survey of Irish domiciled property funds followed in 2020 and in February 2021 the Central Bank published a financial stability note entitled "Property funds and the Irish commercial real estate market" which set out the Central Bank's analysis based on the findings from the survey. In the note, the Central Bank stated that the analysis supports the need to explore the costs and benefits of possible macroprudential policy interventions in this area, to strengthen the property fund sector's overall resilience to potential future shocks.

The proposals set out in the Consultation Paper are based on the potential sources of vulnerabilities identified by the Central Bank as part of its analysis of the sector – leverage and liquidity mismatches.

## Proposed leverage limit

The Central Bank proposes utilising the mechanism under Article 25 of AIFMD, as transposed into Irish law by Regulation 26 of the European Union (Alternative Investment Fund Managers) Regulations 2013, as amended (the "AIFM Regulations"), to impose limits on the level of leverage that an alternative investment fund manager ("AIFM") is entitled to employ in respect of a Property Fund. The current proposal is to introduce a 50% limit on the ratio of a Property Fund's total loans to its total assets and that this limit would apply on an ongoing basis[2].

1 The Consultation Paper states that the calculation of indirect exposure excludes non-redeemable, publically traded shares in entities that are independent third parties to the fund but that this exclusion may be removed in future if it is considered to result in regulatory arbitrage.

2 In practice this proposal will only affect Qualifying Investor AIFs that fall within the definition of Property Fund and currently have leverage in excess of this level. Retail Investor AIFs will not be impacted as they are currently subject to a leverage limit of 30% as detailed in the Central Bank's AIF rulebook.

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In the Consultation Paper, the Central Bank states that the factors taken into account in considering the proposed calibration of the leverage limit included the average, actual European leverage for property funds, the leverage limits that other countries have in place in respect of property funds and that the leverage of Irish real estate investment trusts ("REITs") is also restricted, with the level of borrowings within a REIT not allowed to exceed 50% of the market value of the properties held.

The Central Bank proposed a three year transition period for existing Property Funds that currently exceed this limit and AIFMs will be left to determine the most appropriate way to reduce a Property Fund's leverage during this period in order to ensure compliance with the 50% limit. The proposals set out in the Consultation Paper provide that the Central Bank may seek to impose individual interim limits on certain Property Funds during the transition period in order to ensure that all such funds are deleveraging gradually and appropriately.

The Consultation Paper states that new Property Funds will be expected to be structured to comply with the leverage limit from authorisation.

## Proposed guidance relating to liquidity mismatches

Regulation 18 of the AIFM Regulations sets out an AIFM's obligations with respect to liquidity management of the AIFs it manages. In the Consultation Paper, the Central Bank states that when applied appropriately by an AIFM, the provisions of Regulation 18 should result in the investment strategy, the liquidity profile and the redemption policy of the AIF being consistent. The Central Bank notes however that in practice there is significant variation in the alignment of Property Funds' redemption policies with the liquidity profile of their assets, particularly in periods of market stress. Specifically, the Central Bank has identified that there is significant variation in the timeframe between the point at which an investor's redemption request has to be submitted and the settlement date, the point at which investors receive cash from the fund. The Consultation Paper states that in practice, across the universe of Property Funds, this timeframe varies from seven days to more than three years and that while the Central Bank recognises that there is significant variance in the underlying liquidity of Property Funds' assets, this does not appear to justify the observed variation in their redemption terms.

The Central Bank's proposal to deal with such liquidity mismatches is to issue additional guidance which sets out how Regulation 18 should be applied. The Consultation Paper states that while this proposed guidance is specifically aimed at Property Funds, it may also be used by other types of AIFs when interpreting Regulation 18.

| Proposed Guidance | |
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| **1.** | Property Funds would most appropriately be structured as (i) closed ended or (ii) open ended with limited liquidity. During the design phase for such funds, the board of directors of the AIFM should carefully consider and document what structure may be most appropriate for the proposed fund, taking into account:<br>» the nature of the assets held;<br>» whether a secondary market exists for such assets; and<br>» whether redemption requests could be met without recourse to selling large portions of the fund's portfolio. |
| **2.** | Where a Property Fund is structured as open-ended with limited liquidity, the redemption policies should align with the liquidity profile of the assets.<br><br>The Central Bank expects that the redemption policies of Property Funds provide for a significant timeframe between the point at which an investor must submit a redemption request in respect of a particular dealing day and the point at which investors will expect to receive redemption proceeds from the Property Fund. |
| **3.** | The Central Bank expects that, in considering their redemption terms, AIFMs take into account the liquidity of property assets under both normal and stressed market conditions.<br><br>Central Bank research and property fund managers' own assessments communicated via survey results show that it takes between six and seven months to sell an Irish property asset under normal market conditions. This timeframe is likely to be higher during periods of market stress and/or if a number of Property Funds are trying to sell similar assets at the same time. |

## Proposed Guidance

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| 4. | The Central Bank recognises that there are a number of means through which liquidity mismatches in Property Funds could be mitigated.<br><br>The Central Bank considers that liquidity management tools are complementary to redemption policies that align with the liquidity profile of a funds' assets.<br><br>In addition, the Central Bank expects that Property Funds do not rely excessively on liquid asset buffers to manage liquidity risk, given that this may amplify first mover advantage dynamics. |
| 5. | The Central Bank expects that Property Funds have liquidity timeframes that explicitly allow for a significant timeframe between the point at which an investor must submit a redemption request for a particular dealing day and the point at which investors will expect to receive redemption proceeds from the fund.<br><br>The Central Bank would expect that Property Funds should provide for a liquidity timeframe of at least 12 months, taking into account the nature of the assets held. |
| 6. | Such a liquidity timeframe will assist in ensuring that the redemption terms of the Property Fund align with the liquidity of the assets held in both normal and exceptional circumstances, and in a manner consistent with the fair treatment of investors. |
| 7. | The liquidity timeframe should be appropriately balanced between the notification period and the settlement period, reflecting the importance of each.<br><br>Settlement periods give the Property Fund time to dispose of property assets in order to limit any impact on market prices. However, the notification period plays an additional role, as it assists the AIFM in appropriately managing redemption requests and provides more time to ensure valuations accurately reflect the price they expect to receive, including under stressed market conditions. |
| 8. | The Central Bank expects that those Property Funds that cannot sell their assets within the minimum timeframe consider having longer liquidity timeframes in place, consistent with Regulation 18 of the AIFM Regulations. |
| 9. | The Central Bank would expect AIFMs setting shorter liquidity timeframes in Property Funds to 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 and that they could sell their assets with no material impact on market prices over that shorter timeframe. |

## Conclusion

The proposals set out in the Consultation Paper are aimed at increasing the resilience of the property fund sector by complementing the existing requirements in place in respect of Irish funds. In addition, these proposals tie in with the work being undertaken by the Central Bank to develop a macroprudential framework for the market based finance sector, focusing on the segment of the funds sector that has the closest links with the Irish domestic economy.

## Next Steps

As noted above, the Central Bank is seeking feedback on the proposals set out in the Consultation Paper by 18 February 2022.

If you have any queries on the content of this advisory or would like to contribute to our response to the consultation please speak to your usual contact in Walkers or connect with:

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