ADVICE OF THE EUROPEAN SECURITIES AND MARKETS AUTHORITY

of 23 November 2022

on a proposed measure by the Central Bank of Ireland under Article 25 of Directive 2011/61/EU

In accordance with Article 25(6) of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010[1], the **Board of Supervisors** has adopted the following advice:

I. Legal basis

According to Article 25(6) of Directive 2011/61/EU (AIFMD), the European Securities and Markets Authority (ESMA) shall issue advice on whether the conditions for taking action appear to be met, whether the measures are appropriate and on the duration of the measures.

II. Background

1. On 3 November 2022, in accordance with Article 25(3) of the AIFMD, the Central Bank of Ireland (CBI) notified ESMA and the European Systemic Risk Board (ESRB) of its intention to impose leverage limits under Article 25(3) of the AIFMD on AIFMs established in Ireland managing certain AIFs established in Ireland[2].
2. The measure consists of imposing a 60 per cent leverage limit (calculated as the ratio between the total debt and the total assets of the fund) in respect of AIFs established in Ireland with at least 50% of their assets under management[3] directly or indirectly invested in physical Irish property assets (Irish real estate funds). For this purpose, the CBI defines an indirect investment as ‘any investment undertaking which derives its income from Irish property assets, excluding derivatives, debt instruments, and equities that are traded on open exchanges; and where the underlying asset is controlled by an independent third party to the fund, its managers, its investors, and any delegated authorities of the fund’.
3. Irish real estate funds investing at least 80% of their assets in social housing are not in scope of the measure and Irish real estate funds involved in development activities are permitted to use a different methodological framework for the calculation of leverage.

[1] OJ L 174, 1.7.2011, p. 1.
[2] According to Article 25(3) of the AIFMD, the CBI was not obliged to notify any other competent authority since the measure only concerns AIFs established in Ireland.
[3] The method for the calculation of the total value of assets under management of an AIF is set out in Article 2 of Commission Delegated Regulation (EU) No 231/2013 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (OJ L 083 22.3.2013, p. 1)

4. The proposed measure is expected to apply from 24 November 2022. Real estate funds established on or after this date would have to comply with the leverage limit. Existing Irish real estate funds would be provided with a five-year transitional period to comply. The measure is not limited in duration.

5. The notification of the CBI follows a public consultation[4] in which the authority proposed to introduce a leverage limit of 50 per cent total debt to total assets. Following the feedback received and further analysis, the CBI decided that a 60 per cent limit would better enable funds to manage more localised movements in property values that do not necessarily indicate a systemic concern and, hence, regulatory intervention.

III. On the adverse events or developments

6. The CBI's analysis has established that a cohort of Irish real estate funds have elevated levels of leverage and – on average – Irish real estate funds have higher levels of leverage than equivalent real estate funds in Europe. Moreover, some of these Irish real estate funds are exposed to liquidity mismatches.

7. Following the notification from the CBI, ESMA performed an assessment of the risks posed by Irish real estate funds[5]. ESMA found that 22% of Irish real estate funds (representing 23% of all Irish real estate funds' assets) employed leverage on a substantial basis[6] at the end of 2021, and that a majority of these funds were Commercial Real Estate (CRE) funds. This proportion was significantly above the average level of leverage for EU real estate funds, where only 5% of all real estate funds were substantially leveraged, representing 3% of assets of all EU real estate funds.

8. In terms of actual levels of leverage, Irish real estate funds using leverage on a substantial basis tend to have higher leverage ratios compared to other EU real estate funds using leverage on a substantial basis. 50% of Irish real estate funds using leverage on a substantial basis reported leverage above 677% of their net asset value (measured using the commitment method[7]), compared to 433% for other EU real estate funds using leverage on a substantial basis.

9. AIFs established in Ireland have a large market share in the underlying market, estimated at 35% of the "invested" Irish CRE market. According to ESMA's Guidelines on Article 25 of Directive 2011/61/EU[8] (hereafter referred to as "ESMA's Guidelines"), the combination of leverage and a large market footprint increases the risk for a group of funds to impact market prices in the case of disorderly asset sales. Moreover, the CRE sector is particularly relevant from a systemic risk perspective due to its interconnections with both the real economy and the financial system. The ESRB pointed out that risks originating in the real estate sector can have a systemic impact that is procyclical in nature[9],and recently warned

[4] CP145 - Macroprudential measures for the property fund sector (centralbank.ie).

[5] ESMA's analysis was based on the data collected under Article 24 of the AIFMD that National Competent Authorities transmitted to ESMA at the end 2021.

[6] According to Article 111 of Commission Delegated Regulation (EU) No 231/2013, leverage shall be considered to be employed on a substantial basis when the exposure of an AIF calculated according to the Commitment Method exceeds three times its net asset value.

[7] The Commitment Method for calculating leverage is set out in Articles 6 and 8 of Commission Delegated Regulation (EU) No 231/2013.

[8] 23 June 2021, ESMA34-32-701.

[9] Recommendation of the European Systemic Risk Board on closing real estate data gaps (ESRB/2016/14), 31 October 2016.

against the challenges posed by the deterioration of the macroeconomic outlook to the CRE sector[10].

10. The CBI reported that Irish real estate funds were also exposed to liquidity mismatches for approximately[11] 40% of their assets. According to ESMA's Guidelines, liquidity mismatches can increase the risk of fire sales, in particular in stressed market conditions.

11. Considering the high level of leverage reported by a part of Irish real estate funds and their large market footprint on the CRE market, they have the potential to amplify shocks affecting this market through disorderly asset sales, with broader macro-financial implications. In addition, the existence of liquidity mismatches for a subset of these funds increases the risk of disorderly deleveraging in stressed market conditions. Therefore, ESMA considers that the conditions for taking actions are met.

IV. On the appropriateness of the measure

Leverage limits

12. The CBI proposes to introduce a limit of 60% to the ratio debt over total assets of the funds. In the context of ESMA Guidelines, this is equivalent to a 150% limit to the financial leverage ratio (measured as the value of borrowings as percentage of NAV) and a 250% limit to the gross leverage (measured using the gross method[12] for calculating the exposure of the AIF), to the extent that funds do not have recourse to another source of leverage. Indeed, while the proposed limit applies to borrowing, funds could in principle reach higher levels of leverage by using synthetic leverage.

13. ESMA assessed the source of leverage of Irish real estate funds and found that they were primarily gaining leverage through borrowing. Half of Irish real estate funds employing leverage on a substantial basis reported a financial leverage ratio above 588% (639% among CRE funds), compared with 213% for other EU real estate funds. Moreover, investments in financial derivative instruments by these funds were non-material. Therefore, considering that the proposed measure will address the actual source of leverage of Irish real estate funds, ESMA finds it appropriate to base the limit on the level of funds' debt and not to include financial derivative instruments.

14. However, ESMA advises the CBI to closely monitor the evolution of leverage through the use of financial derivative instruments by these funds, in order to assess the merit of including them in the future, should they also create a risk to the stability of the financial system.

15. The calibration of the leverage limit by the CBI is based on the actual observed leverage in other EU jurisdictions as well as the leverage limits that exist for other property entities in Ireland. In particular, in its consultation on the limit, the CBI explained that the proposed

[10] Warning of the European Systemic Risk Board on vulnerabilities in the Union financial system (ESRB/2022/7), 22 September 2022.

[11] The CBI assessed the liquidity mismatch by comparing the liquidity timeframe of the funds and the liquidity of the portfolio of the fund. For that purpose, the CBI defined the liquidity timeframe as the maximum length of time between the point at which an investor can request a redemption and the point at which the fund must pay out that redemption. The expected time to sell a property to meet redemption requests will depend on the liquidity of the underlying market. Liquidity timeframes that are shorter than the expected time to sell property assets would be indicative of liquidity mismatches in funds.

[12] The Gross Method for calculating leverage is set out in Articles 6 and 7 of Commission Delegated Regulation (EU) No 231/2013.

50% leverage limit took into account (i) the average actual European leverage for property funds, which in 2020 was around 25%; (ii) historical experience of CRE markets being more volatile in Ireland than in many of their European counterparts; (iii) leverage limits already applicable in other jurisdictions such as Germany, where a 50% limit is applied to spezialfonds; and (iv) the leverage of real estate investment trusts in Ireland, where the level of borrowings within the company is not permitted to exceed 50% of the market value of the properties held under national law.

16. The limit was adjusted to 60% (against 50% initially proposed) following the feedback from the consultation. The CBI especially considered that this would give some flexibility to fund managers above the initially desired level of 50%, especially in case of localised movements in property values.

17. ESMA notes that the proposed level of 60% would prevent Irish real estate funds from becoming substantially leveraged and would bring their level of leverage closer to the level observed for other EU real estate funds. Considering the challenges that the deterioration of the macroeconomic outlook could pose to the CRE sector, such limits should contribute to improving the resilience of real estate funds ex-ante and to limiting the build-up of risk in the CRE sector, including any procyclical behaviour. Therefore, ESMA finds the limit of 60% appropriate to address the risks identified.

Exceptions

18. Irish real estate funds involved in development activities will be allowed to use a different methodological framework for the calculation of leverage. This is a due to the fact that the proposed leverage calculation of total debt to total assets is predicated on the value of completed (investment) assets. It does not account for the cost-based valuation of development assets. As such, a 60% leverage limit based on the completed asset valuation would, in practice, result in much tighter leverage limits being applied to development activities as these are valued on a cost-of-production basis, which is generally lower than completed asset valuations. Therefore, during the duration of the development phase, these funds would have the right to apply a margin to the development assets. The margin will work as an estimate of the final value upon completion of a development project, thereby accounting for the difference between costs of development and final valuation, and will be provided by the CBI. Based on the information communicated by the CBI, only four of the funds identified as development funds had a leverage level over 60% with a limited value of assets under management.

19. In addition, funds investing at least 80% of their assets in social housing would not be included because, according to the CBI assessment, the social housing market has lower vulnerabilities due to its characteristics and do not pose the same financial stability risks as other real estate funds. The key characteristics are that these funds operate with long term leases where the properties owned by a fund (or properties that are being developed by a fund) are leased (or pre-leased) to a local authority for up to 25 years and the local authority will pay rent of up to 95% of the market rent to the fund for the period of the lease (regardless of whether the property is occupied, or market conditions, for example).

20. Excluding funds on the basis of the systemic risk they pose and establishing a bespoke leverage calculation to accommodate the characteristics of a well-defined type of real estate funds, is consistent with the principle of proportionality stated in ESMA's Guidelines. ESMA advises the CBI to monitor the evolution of funds involved in development activities and investing in social housing to assess the relevance of this exemption.

Transitional period

21. Whereas Irish real estate funds established after the publication of the measure will have to comply with the leverage limits immediately, existing Irish real estate funds are permitted to implement the limit over a five-year period to avoid procyclicality caused by unintended and sudden deleveraging. ESMA is of the opinion that the implementation phase of five years provides enough time for Irish real estate funds to comply with the proposed leverage limits and is consistent with ESMA's Guidelines which recommend implementing leverage limits progressively to avoid procyclicality.

22. However, ESMA advises the CBI to encourage Irish real estate funds not to take advantage of the implementation period to delay unnecessarily their compliance with the leverage limits. Therefore, ESMA considers that such funds should comply as soon as possible to the extent that the deleveraging does not entail additional pressure on the underlying market. In particular, when planning for an orderly deleveraging, real estate funds should consider not renewing debt maturing before the end of the proposed five-year implementation period.

V. On the duration of the measure

23. The measure proposed by the CBI is continuous and does not include any duration. This is consistent with ESMA's Guidelines according to which the limits should be maintained for as long as the risks posed by the AIF or the group of AIFs do not decrease. Such risks are exacerbated by the impact of the deterioration of the macroeconomic environment on the CRE market in which real estate funds have a large market footprint. Therefore, ESMA considers that not limiting the duration is appropriate.

VI. Conclusion

24. For the reasons above, ESMA considers that the leverage limit proposed by the CBI is appropriate to address the concerns relating to the stability and integrity of the financial system. ESMA recommends that the CBI closely monitors the evolution of the Irish real estate sector to assess the relevance of its measure and the necessity to recalibrate the leverage limit.

Done in Paris, 23 November 2022

For the Board of Supervisors
[Signed]

Verena Ross, ESMA Chair
[Signed]