EBF_046568
12.08.2024

EBF response to the EBA consultation on draft technical standards on equivalent mechanism for unfinished property under the standardised approach of credit risk

General comments

Through the CRR provision of Article 124, banks should be able to benefit from the possibility to consider unfinished residential property as eligible collateral for the purpose of RWA computation.

For properties in construction related to an ADC program, the CRR allows for the recognition of such properties as eligible collateral when their completion is insured by a sovereign entity or alike. Such type of scheme is at the best very unusual, not to say unknown to banks. The EBA mandate aiming at clarifying what is an equivalent legal mechanism to the above and allowing for unfinished collateral recognition is thereby highly welcomed by banks. This is especially true in the context of the recent difficulties encountered by real estate developers across Europe.

Nevertheless, within its mandate, the EBA has defined as equivalent mechanisms only these mechanisms whereby the completion guarantee is not provided by a sovereign entity or alike but counter-guaranteed by the later. Again, such situation is unknown to banks which means that this EBA position would leave the EBA mandate without any effect.

We thus urge the EBA to reconsider its alternative approach that is to recognize completion guarantee provided by financial sector entities when they are mandatory by Law as a legally equivalent mechanism. Indeed, we want to recall that the drawing on such financing is contingent to the achievement of a tranche of work and will be made available to the client only upon the related capital call presentations. Thanks to the completion guarantee mechanism which gives high degree of certainty to a secondary buyer, the unfinished property can be disposed for a value reflecting its stage of completion in a standard way. Hence, should a client default prior to the immovable property completion, the outstanding amount of its loan will be fully secured by the unfinished property value. Ignoring the consequences of this legal mechanism will unduly force to not consider any security on the amount owed to banks.

When it comes to the undrawn part, this would also go against the substance of CRR Article 193.7: " *Collateral that satisfies all eligibility requirements set out in this Chapter can be recognised even for exposures associated with undrawn facilities, where drawing under the facility is conditional on the prior or simultaneous purchase or reception of collateral to the extent of the institution's interest in the collateral once the facility is drawn, such that the*

institution does not have any interest in the collateral to the extent the facility is not drawn.'; indeed when the facility is drawn, it is to pay for the achievement of a tranche of works which translates into an additional value of collateral in which the bank has interest.

When we acknowledge here the necessity to have some safeguards to ensure the robustness of such a completion scheme (such as minimum credit quality for the protection provider or capital requirements conditions), we are of the opinion that the alternative approach should be further adapted to make it applicable, notably considering the below:

- Given the specificity of a by Law completion guarantee, which takes rather the form of a "cautionnement"/performance bond whose activation is contingent to both the financial discrepancy of the real estate developer and its failure in its contractual duty to complete the building, the eligibility criteria contemplated by the EBA cannot be exactly the same as the ones applicable in the context of a credit protection recognition.
- The alternative approach relies on the RW substitution under the standardized approach: the EBA mandate is limited to the specifFReication of what an equivalent legal mechanism is, without any provision for changing the CRR risk-weighting method
- The preclusion of completion guarantee providers belonging to the same group as the lending entity is an over penalizing provision leading to RWA double-counting – note this is a common practice for multi-activities banks to grant the completion guarantee while another business finance the mortgage loan. Also, this preclusion is questionable as it does not recognize the well-established risk management practices deployed by banks.

We made more detailed suggestions in line with the above remarks in the below section.

EBF response to the consultation’s questions

Q1(a): Are there some practical cases where a central government, regional government or local authority or a public sector entity involved, exposures to which are treated in accordance with Articles 115(2) and 116(4) of the CRR, respectively, has the legal powers and ability to ensure that the property under construction will be finished within a reasonable time frame and is required to or has committed in a legally binding manner to do so where the construction would otherwise not be finished within a reasonable time frame (i.e. existence of cases referred to in Article 124(3)(a)(iii) of the CRR)?

If such cases should exist, they are clearly very remotes ones.

Q1(b): Are there some practical cases where legal powers and ability to ensure that the property under construction will be finished within a reasonable time frame is given to an entity that is neither a central government, nor an entity for which exposures are treated in accordance with Articles 115(2) or 116(4) of the CRR (i.e. existence of cases referred to in the current Article 1 of the RTS)?

In several European jurisdictions (France, Belgium, Luxembourg) where the completion guarantee are mandatory by Law, eligible providers are only financial sector entities (e.g. banks, insurers, guarantee firm) without any counter-guarantees requirement. Such market reality makes EBA proposal of Article 1, as a pure extension of a very remote case where the construction finalization might be insured by a sovereign or alike counterparty, simply non applicable. We are thus of the opinion that the EBA should strongly reconsider its contemplated alternative approach in the finalization of the RTS. This alternative approach should still be better adapted as described later in this document.

Q2: With regard to subparagraph (d)(iii)(first indent) above, could you provide insights into how pledging the rights under the completion guarantee functions from both a legal and practical perspective? Specifically, in current market practices, are the rights pledged only upon the default of the obligor? If so, are any measures being considered or implemented to mitigate the legal risks associated with the pledge potentially needing to be upheld by the insolvency administrator under applicable insolvency law, and at last to ensure effective protection of the institution's interests?

There is no direct ex-ante pledge of the completion rights at origination or in case of default. However, two situations may be distinguished in case of default of the obligor prior to completion[1] through the mortgage activation:

i) either the bank repossesses the immovable property and manages to have a sale executed: in this situation, until the sale, the client remains the owner of the property and the beneficiary of the completion guarantee in case of failure of the developer; any capital

[1] We want to recall here that the outstanding amount of the loan upon default reflects the state of completion of the property thus the collateral value

call occurring after default (due to works achieved by the developer or by completion guarantee activation) and before the sale would be financed through an additional drawing on the loan and the collateral potential sale price would have increased accordingly; through the mortgage lien the bank can claim for sale proceeds up to the mortgage referenced value (usually the loan total authorization) and would thus benefit from any additional value reflected in the price due to any kind of completion achieved after default.

ii) or the bank repossesses the immovable property and eventually becomes the owner of the property: I completion right is attached to the property and can only benefit to its owner. Hence, in this case the bank fully becomes the owner of the property for a value reflecting its stage of completion and at the same time the beneficiary of the completion guarantee. The bank will thereby benefit from the same protection in case of failure of the developer up until it managed to proceed the disposal of the property, which is thus facilitated.

This way of operation makes this eligibility criteria *(d)(iii)(first indent)* unnecessary for the recognition of an equivalent legal mechanism in the form of completion guarantee since its effect on the banks' interests are already addressed by the legal certainty requirements to be met for immovable property collateral recognition (CRR 208.2) or through proper transfer of ownership. .

Q3: Could you provide the RW assigned to the entities that are currently protection providers for such completion guarantees, as well as the type of counterparty (i.e. financial institution, other financial sector entity or corporate)? Would, in view of these RW, the alternative treatment as financial guarantee achieve sufficient recognition of completion guarantee?

As stated in Q1, the completion guarantee providers are financial sectors entities, mainly banks and insurers.

When it comes to insurers, they belong to the corporate exposure class for which a 20% RW corresponds to a CQS1 - [AAA/AA] rating under the standardized approach. Banks belong to the institution exposure class for which a 20% RW corresponds to a CQS1 - [AAA/AA] rating too. Hence, very few European banks or insurers would benefit from a 20% RW following the CRR Art. 138 conservative rules of selection of an external rating among multiple external ratings.

Note that this does not even consider the provision of CRRIII article 113 regarding the due diligence on external rating that may lead to higher risk-weighting.

We understand that EBA considers that a 20% RW is relevant by reasoning through a substitution approach whereby there would be no distortion versus the Loan Splitting RW applicable to the part of an exposure secured by a finished property. When we acknowledge the necessity of having safeguards in relation to the capital requirements to which the protection provider is subject as well as in regards of its credit quality (for instance a minimum CQS of 2), we are of the opinion that the 20% RW is far too conservative and would disqualify many protection providers in order to benefit from the CRR disposition. Furthermore, the EBA approach unduly excludes unrated banks, which bear a minimum RW of 30% or 40% if they are classified under grade A as per article 121.2 of the CRR3.
We are also not supportive of the alternative substitution approach on the part of the exposure secured by the immovable property that would consist in risk-weighting this part with the protection provider RW.

Indeed, we want here to recall that:

- Completion guarantees are rather performance bonds (since also contingent to the failure of the developer in its duty in regards of the construction achievement) not pure financial guarantees for which substitution is applicable
- CRR has never considered a substitution approach for completion guarantee on the part of an exposure secured by unfinished property; the EBA mandate is limited to the specification of what constitutes an equivalent mechanism that gives enough certainty about the completion without any provision for changing the CRR risk-weighting approach.
- Considering that the unexpected losses on the part of the loan secured by the unfinished property is the same as the one of a direct exposure to the completion guarantee provider is ignoring that the borrower must have early defaulted while there was at the same time an event preventing the developer to finish the property so that the lending institution is economically exposed to the completion provider. This would rather tend to justify a lower applicable RW than the one of the completion provider: the secured RW of 20% is still relevant when there is an equivalent legal mechanism regardless of the RW of the completion guarantee provider.

Q4: In the case where the requirements on the guarantee would be limited to cover the simple case where the construction works are impeded by financial difficulties faced by the real estate developer, which other mechanisms could ensure the appropriate recognition of the construction risk beyond the creditworthiness of the real estate developer in the own fund requirements?

The failure of the real estate developer in its contractual obligation is mainly resulting either from financial difficulties or from fraudulent behavior and equivalent (non-compliant delivery). This latter risk that could jeopardize the achievement of the construction is mitigated as per the below:

- Banks are required to perform enhanced Know Your Customer due diligence whereby the activity, reputation, ownership, business history etc. of the real estate developer are to be screened out before it is onboarded as a client.
- Buyers have legal recourse whereby the court can recognize the failure of the real estate developer in its contractual obligation and have it finalize the construction or can designate a competent third party to identify and perform the required works.
- In France, sale of property under construction is a regulated activity, as a result construction works are subject to multiple mandatory insurance schemes to secure the building operations: builder's liability insurance ("tous risques chantier"), two years warranty on equipment, mandatory insurance on the building's defects after completion (assurance "dommage-ouvrage")

In addition, as a general remark regarding point d), we would like to highlight again that such completion guarantees are rather performance bonds (since also contingent to the failure of the developer in its duty in regards of the construction completion) whose mechanism is framed by dedicated consumer protection Law but not pure financial guarantees. As such they cannot meet exactly the same eligibility criteria than the ones required by CRR for the recognition of guarantees as credit risk mitigant. This would lead to supersede national Law requirements in terms of guarantee eligibility. The fact that they are enforced by Law in a mandatory manner shall thus be sufficient for their eligibility for

the purpose of having enough certainty of the finalization of a real estate property taken as collateral.

When it comes more specifically to point d)iv), we strongly disagree with the proposal of restricting protection providers to entity without any link with the lending institution. If we take the case of a lending institution that is also the completion guarantee provider, this institution will compute RWA related to the UL generated by the completion guarantee. If this UL materializes, it means the completion guarantee has been called, which generates losses reducing own funds of the institution as a protection provider. Now if these losses are accounted for, it means that the real property is going to be finalized, to the benefit of the institution as a provider of a collateralized loan in case of the borrower's default. Disallowing to recognize the effect of such a completion guarantee will on the contrary lead to have more UL/RWA generated by the loan provided to the buyer since considered as unsecured. This would generate a double counting of RWA for losses that cannot coexist.

Furthermore, the rationale underpinning the EBA proposal is questionable in terms of risk management for the following reasons:

- From a bank's perspective, providing a completion guarantee to the real estate developer and financing a mortgage loan are two different risks by nature, which follow specific risk assessments and prudential treatments in the CRR3. Each risk is therefore properly managed by the bank, adequately priced and it is covered by dedicated own funds requirements.
- Contrary to what the EBA suggests, we believe that combining the roles of guarantor and lender gives banks a comprehensive control of the risk borne by the different phases of the real estate project. Such a pattern notably provides banks the right incentives to achieve the real estate building in case of failure of the real estate developer, to the mutual benefits of the bank and of buyers. It is worth noting that buyers generally prefer having one single bank responsible for both roles.
- Finally, separating the completion guarantee from clients' financing would unduly disrupt smaller markets, where only a few banks are active in the real estate sector, and where it frequently happens that banks complete both tasks.

Conclusion on completion guarantee eligibility criteria

All in all, we suggest adapting the conditions a) to d) as per the below:

- Point c) - the minimum level of creditworthiness should not be based on RW but instead be set to a minimum CQS of 2 without any RW substitution. When it comes to unrated banks, it should be referred to those classified under grade A as per article 121.2 of the CRR3.
- Point d)ii) - this condition should only be applicable when the contractual arrangement of the completion guarantee provides also for reimbursement guarantee, which is not necessarily mandatory
- Point d)iii)
    - First indent should be erased (see answer to Q2)
    - On the third indent, completion guarantee contract may contain exclusion clause of Force Majeure event; nevertheless, such clause should not be disqualifying since the realization of this type of event is either highly likely to have a very detrimental impact on the value of a finished property too or

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covered by home insurance, that is usually contracted by the buyer before the full completion.

  - On the fourth indent, we need to have confirmation that the preclusion of clause preventing *"the protection provider being obliged to finish the construction [..] in a timely manner"* is to be read as a clause that would allow the protection provider to finish the property only before a given date that is beyond the usual period requested for construction. Otherwise, the timely manner condition would be too stringent given the specificity of the protection.

- Point d)iv) should be erased (see Q4)

Q5: Which specificities of IPRE and non-IPRE exposures could warrant differentiated requirements on the equivalent mechanism?

This substitution method proposal, in addition to its other limitations highlighted in this document, would be only applicable in the context of the application of loan splitting approach, i.e. for non-IPRE exposures or some specific IPRE ones. This approach is not consistent across exposures secured by immovable property and would thereby unduly penalize IPRE loans. We are thus of the opinion that the proposal is going too far in fully considering the completion guarantee as a credit risk mitigant. This view relies on the fact the guarantee is not here to protect the bank against the default of its client but allows the bank to consider with enough certainty that the collateral reaches in average its value upon completion. The RW substitution should not be contemplated.

Moreover, IPRE and non-IPRE qualify the use made by the buyer of the residential unit, and they are not relevant criteria to assess the risk of non-completion of the property. Finally, such a differentiation is not specified in the mandate granted to EBA by art. 124.12 CRR3.

Q6: Could you provide empirical evidence of cases where a sovereign outside Europe has intervened to complete an unfinished property?

Q7: The text of Article 124(3)(a)(iii)(second indent) refers to the completion of the property under construction within a reasonable time frame. What is the average time for the protection provider to step in once the real estate developer fails to meet its obligations? What is the average time for the protection provider to complete the construction of an immovable property, once the completion guarantee is triggered? For the previous responses, please specify at what stage the construction was and how many housing units it comprised, if such data is available.

Q8: Do you have any empirical evidence regarding the historical average loss rates for both real estate developers and entities providing completion guarantees? If available, please provide the pertinent empirical data

Q9: In order to conduct a comprehensive assessment of the completion guarantee risk, could you provide data related to the following indicators over the longest possible time horizon on a yearly basis: [for data collection purposes, we assume that there is only one completion guarantee per project, so that a credit institution should not double count the trigger of a completion guarantee for several housing units in the same property]

b) Ratio of number of times completion guarantees have been triggered over the total number of projects covered by the guarantees.

c) Ratio of number of times completion guarantees have been triggered and resulted in completion divided by number of times completion guarantees have been triggered.

d) Ratio of number of times completion guarantee have been triggered and were ultimately transformed into repayment guarantee divided by number of times completion guarantees have been triggered.

e) For cases where the Real Estate Developers (REDs) defaulted, ratio of number of times completion guarantees have been triggered but for which the protection provider failed to meet its obligations (e.g. due to deficiency of the protection provider) divided by number of times completion guarantees have been granted.

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