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Finance for Europe

Association for Financial Markets in Europe

AFME response to EBA consultation paper on Draft Guidelines on ADC exposures to residential property under Article 126a of Regulation (EU) 575/2013

1 August 2024

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the EBA consultation on Draft Guidelines on the management of ESG risks. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Executive Summary

We welcome the work that has been done by the EBA to structure the different ratios in such a way that they are simple to calculate and there is little room for interpretation.

However, in relation to the calibration of these ratios, we are surprised that they have been set far beyond market practices at EU and non-EU level, and that some are even impossible to achieve given the regulations in force in some jurisdictions.

Considering these Guidelines will impact on international European banking groups, these Guidelines should also align with non-EU countries market practices. As currently drafted, these Guidelines would create an uneven playing field for EU banks in third countries when consolidating at the EU level.
We therefore ask the EBA to consider these elements when reviewing the thresholds proposed in the consultation.

In addition, we further think that EBA should bring more clarity on the type of construction financing that fall into the ADC exposure class. For instance, a loan granted to a corporate to finance the construction of its headquarter or another building for its own usage, for which the repayment is fully linked to its capacity as a commercial undertaking and not on future uncertain cash flows materially linked to a specific real estate project, shall not be classified as ADC. The industry is of the opinion that such a financing, and other situations with similar risk characteristics, shall not necessarily attract an ADC treatment.

We would also appreciate if the EBA could provide a clarification on its reference to 'lease' in the draft Guidelines, in particular whether the EBA's use of this term covers both lease and rent arrangements.

<u>A. SUBSTANTIAL CASH DEPOSIT:</u>

Q2: Do you agree with the approach proposed to specify the term “substantial cash deposit”?

The proposed threshold would fit for some jurisdictions; however, this was not the case for other jurisdictions.

Q3: Do you consider the 10% ratio to be appropriate for the determination of the ADC exposures benefitting from the lower risk weight?

As raised in Q2, the proposed ratio would fit for some jurisdictions; however, this was not the case for other jurisdictions. The EBA 10 % ratio goes beyond the legal requirement of certain jurisdictions. Some jurisdictions may have chosen a low cash deposit rate given other risk-reducing mechanisms.

For example, in France, the recourse to VEFAs and single-family home constructions (Article R261-28 of the French Construction Code) limits the cash deposit paid by the purchaser to 5% of the estimated sale price “if the time limit for making the sale does not exceed 1 year” and 2% if it does not exceed 2 years.

By proposing a minimum cash deposit amount of 10% of the sale price on pre-sales (no minimum cash deposit amount is mentioned on sales), the EBA hampers the possibility for French banks to apply a reduced RW, in an earlier stage of the project, since they would no longer be able to use pre-sales (i.e. reservations) in the calculation of the significant portion of total contracts. pre-sale.

This rate therefore poses a problem of an uneven playing field among European countries.

Q5: Do you see any drawbacks in adopting the selected option? In case you prefer the alternative option, could you provide the rationale and an example of the calculation and estimation of the net present value of total payments?

Yes. Proposed ratios related to substantial cash deposit would only make sense for pre-sale and sale binding contracts. In the case of pre-lease and lease binding contracts, we do not see the case where individuals are going to pay 3 months in advance for renting a flat that is still under construction. This would be the case for pre-lease agreements for commercial shopping centers and offices, that are out of scope of this consultation and the EBA’s mandate.

Q7: Do you have any concerns with applying a single threshold to all ADC projects? Are there any practical options the EBA should consider setting the threshold in a more granular way, keeping in mind the simplicity of the Standardised Approach and the level playing field across institutions? If yes, please elaborate these options in detail.

For the sake of simplicity, the same single threshold should apply to all ADC projects. However, it is of the utmost importance that the proposed ratio covers all market practices, not only at EU level but also non-EU level, considering these Guidelines also impact the most international European banking groups.

Q8: Is the relation between the “substantial” cash deposit required for a pre-sale contract and the “substantial” cash deposit required for a pre-lease contract appropriate from your perspective? If, not, please explain why and how this relationship should be adjusted.

As flagged in our response to Q5, in the case of pre-lease binding contracts, we do not see the case where individuals are going to pay 3 months in advance for renting a flat that is still under construction. This would be the case for pre-lease agreements for commercial shopping centres and offices, that are out of scope of this consultation and the EBA's mandate.

B. FINANCING ENSURED IN AN EQUIVALENT MANNER

Q9: Do you agree with the approach of strict equivalence with respect to cash deposit proposed? Do you deem other forms equivalent to the cash deposit from a risk perspective? If yes, please explain.

Yes, we consider this fits with the current market practices.

C. SIGNIFICANT PORTION OF TOTAL CONTRACTS

Q10: Do you agree in using two different options for pre-sale/sale and pre-lease/lease contracts?

We do not agree with the setting of two different options for pre-sale and pre-lease contracts. We do not understand the rationale behind asking for a % of sale price for pre-sales and a % of total contracts for pre-leases. Instead, we would support a credit facility based approach.

Moreover, we find that the proposed thresholds are too high.

Q11: Do you see any drawbacks related to the proposed options under paragraphs 14 to 16 of these Guidelines?

We welcome the EBA credit-facility based approach since it ensures a more comprehensive assessment of risk: measuring the significant portion of total contracts in regards of the loan granted is more risk sensitive and ensures that the RW will be lowered only when legally binding pre-sales and sales amounts reach a significant amount of the loan facility, i.e. when i) the construction risk is mitigated since the residual financing gap is sufficiently reduced and ii) in material proportion of the loan amount.
However, by proposing a threshold of 50%, the EBA goes beyond the rate recommended by the profession and market practices.

For pre-lease and lease, as being flagged previously there are many jurisdictions where there are no pre-lease contracts. Therefore, institutions would not profit from the approaches taken in this respect.
For presale and sale contracts, we consider the proposed 50% ratio is too restrictive and would make very difficult to comply with it considering the current EU and non-EU market practices.

It should be noted that some European banking groups operate and are located in third countries, such as Latin America and non-EU European countries. That means these banks must comply with EU rules while competing locally considering local market practices specificities. If EU rules do not take into account third countries local market practices, which is the case for the proposed ratio, this ratio would pose a problem of an uneven playing field for the most international European banking groups that consolidate its activity at the EU level. Therefore, we would suggest reducing the proposed percentage to 40-45%.

Indeed, while the background and rationale section consider that this condition is meant to mitigate the risk of the absence or scarcity of marketability of ADC projects, we would like to highlight that a higher ratio does

not necessarily mean that it is a better project and that the project could better absorb a negative market shock (as would be the case for more profitable projects with a level of presale and financing over the market practice). However, less profitable projects (with less capacity to absorb losses and significant financing) may fit the ratio with a slightly higher pre-sales level, without benefitting from the cushion of protection provided by enhanced profitability. This is also to be considered in the lowering of the threshold.

Q12: What is the materiality of ADC projects with mixed use foreseen? How are these projects structured and whether the proposed options raise any particular issues to be applied in practice?

Projects with mixed use are not material from our members perspective. Considering there are many jurisdictions where there are no pre-lease contracts, no ADC projects with mixed use are identified by our members.

D. APPROPRIATE AMOUNT OF OBLIGOR-CONTRIBUTED EQUITY

Q18: What are your views on the proposed threshold for determining the appropriateness of the amount of obligor-contributed equity? Please provide reasoning, taking into account market practices and underwriting standards if you think that an adjustment of the EBA's proposal is necessary.

We do not agree with the proposed ratio. We consider the proposed threshold is overly prescriptive. While the background and rationale section considers that "an appropriate amount of obligor-contributed equity can mitigate the risk of the ADC exposure covering potential unexpected losses in case of adverse market price movements until a buyer/tenant is found and the price is fixed by sale/lease contract" (Page 8, section 1.4); expected profit is not taken into account when defining the numerator, therefore when finally selecting the approach and defining the threshold.

However, when considering the denominator, the expected profit is taken into account due to the Property Value upon completion.

First, as being flagged by the industry during the EBA's Public Hearing held in June 2024, the obligor´s substantial equity at risk should not be determined as part of the value of the property upon completion, rather than as on the total financing costs. Institutions do not finance the total value of the property upon completion, but at maximum the total financing costs. That makes the proposed ratio (>=35%) too restrictive.

The proposed approach would lead to the rejection of the 100% RW treatment for the greater added value projects or would require conditions to be met that are not present in the market, while benefiting lower added value projects that we understand is not the aim of the EBA's proposed measure.

Considering the EBA's comments during the Public Hearing that the denominator could not be modified to fit with current market practices as it is binding defined from the CRR3 Level 1 text/ Article 126(a), we would instead propose Option 1 to reduce the requested percentage.

Q19: Do you agree to use Approach 4 for identifying the appropriate amount of obligor contributed equity? If not, what alternative options should the EBA consider?

We would agree to use approach 4 should the proposed threshold be reduced as per the rationale explained in our responses to Q18 and Q20, and considering the Level 2 text cannot modify the proposed denominator (value of the property upon completion).

If this was not the case, we would suggest an alternative approach where the expected profit was also considered in the numerator, not only in the denominator as follows:
(Property value upon completion – Total loans – Cash proceeds[1])/ Property value upon completion ≥ 30%

Example:

Sale price	115
Cost	100
Profit	15
Debt	70
Equity	20
Cash deposit	10
Total cost	100
	115 - 70 - 10 = 35
	35/115 = 30%

Property value upon completion & Land Financing

Here we need to recall first the definition of ADC exposures which *"means exposures to corporates or special purpose entities* ***financing any land acquisition for development and construction purposes****, or* ***financing the development and construction of any residential property or commercial immovable property****"*. The definition thus encompasses both land financing and/or construction financing.

The proposed threshold considers the *Property value upon completion* as the reference to calculate the amount of obligor-contributed equity. This approach assumes that ADC projects are financed upfront as a whole package, which does not reflect situations where only the land acquisition is financed for the purpose of later construction that would be self-financed by sales.

In some jurisdictions, the most common case is where banks finance solely the land acquisition by the real estate developer. In such a situation, there is no meaningful economic ground to consider as a risk mitigant an obligor-contributed equity ratio which is based on the whole property value upon completion since the loan does not totally finance the entire property value.

We are of the opinion that if EBA should therefore clarify that in the context of land financing only, the property value upon completion should be understood as the land value. If other approaches such as approach 3 are retained, the *Total Costs of the Project* should also be considered in regards of what is financed only, i.e. the land acquisition cost.

This would be consistent with the CRR definition of "property value" and "residential property"

[1] These can take the form of deposits or proper payments.

‘(74a) “property value” means the ***value of a residential property*** *or commercial immovable property determined in accordance with Article 229(1);’;*

‘(75) “residential property” means any of the following:
(a) an immovable property which has the nature of a dwelling and satisfies all applicable laws and regulations enabling the property to be occupied for housing purposes;
(b) an immovable property which has the nature of a dwelling and is still under construction, provided that there is the expectation that the property will satisfy all applicable laws and regulations enabling the property to be occupied for housing purposes;
(c) the right to inhabit an apartment in housing cooperatives located in Sweden;
(d) land accessory to a property referred to in point (a), (b) or (c);[2]’

Q20: Do you see any rationale for setting different threshold levels?

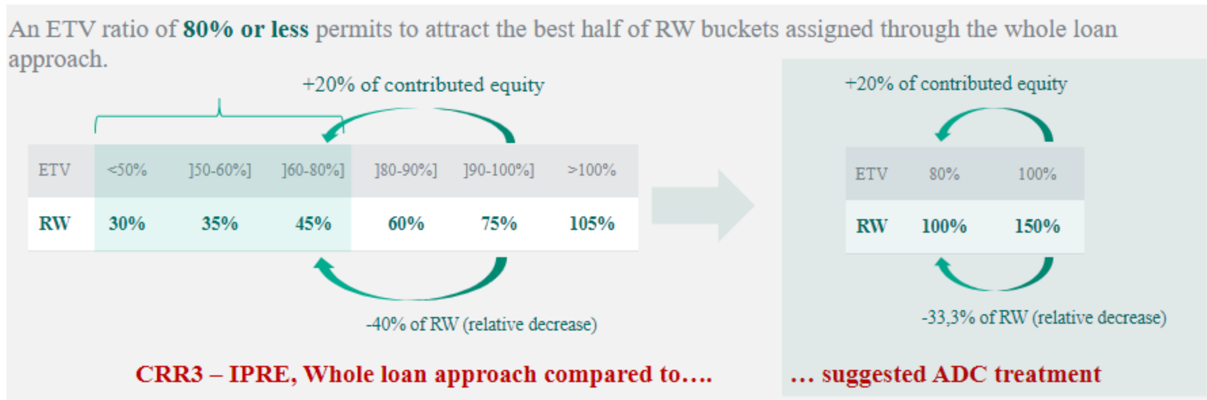
Threshold level
The EBA explains that the threshold level of 35% is justified for the lowering of risk weight from 150% to 100% because it exceeds current market practices. While we understand this rationale, we believe that the proposed level is too excessive since it is not based on transaction types and specificities (expected profit notably) and thus may not be reached in average across European market practices. We are therefore afraid that this level of threshold will simply disqualify the Level 1 text derogation based on a significant obligor-contributed equity.

35% of value upon completion (65% Loan-To-Value upon completion) seems unduly conservative and decorrelated from the level of equity contributed that would effectively mitigate the risk.

Indeed, by analogy with IPRRE loans under whole loan approach (CRR article 125.2) that shares similar features in terms of approach (i.e. level of RW depending on ETV : 1-% obligor-contributed equity), a 20% obligor contributed- equity is deemed significant and appropriate to reach a 40% relative RW decrease (from 75% for an ETV =100% to 45% for an ETV=80% - see figure below).

The threshold level to be set in the context of ADC exposure would lead to a less significant mitigation of 33% relative decrease (from 150% to 100% RW). We are thus of the opinion that a level of obligor contributed equity of 20% would be significant enough and appropriate since ensuring proportionality to the IPRRE treatment while taking into account the additional construction risk through the lower extent of risk weight reduction.

[2] Income Producing Residential Real Estate



Therefore, we would ask EBA to consider a threshold of 20% instead of 35%. This ratio remains also above the average observed in European markets which would ensure meeting the substance of the EBA proposal for lower RW application.

We are of the opinion that this would also be consistent with the EBA RTS on RE specialized lending slotting approach, where favorable risk weights are applicable for satisfactory or low level of LTV.

Q21: Do you agree with the adjusted criteria for public housing or not-for-profit entities?

The Guidelines seem to be very punitive towards the public housing companies and pose a problem of non-applicability of the 100% RW, as none of the criteria could be fulfilled (equity, pre-sale rate, cash deposit). It seems questionable that these kinds of exposures have a higher capital charge (150%) whereas they are less risky. The thresholds defined by the EBA should at least be equivalent to those of traditional leasing.

As flagged previously there are many jurisdictions where there are no pre-lease contracts. Thus, institutions would not profit from the approach taken in this respect.

Therefore, we would suggest broadening the scope of an adjusted criteria for public housing and non-for-profit entities to sale. In many jurisdictions while there are no pre-lease contracts, public housing and not-for profit entities sales are market practices.

The consultation requires that pre-lease/lease contracts represent at least 75% of total lease contract. We do not understand the economical rational that would justify having 75% rate for social housing when it is only 50% for the classic private sector. Besides, this criterion is not relevant for social housing mainly because the social landlords have no problem occupying their building and real estate financing from social landlords is not reimbursed solely on the income/rents of the financed building,but based on all the resources/rents from the social landlord's real estate assets.

Considering the substantial cash deposit of one month rent, this criterion is also not applicable. In France, for example, pre-lease contracts between a social landlord and a tenant who is a natural person (private customers) during the construction of the property do not exist. It is impossible to rent to a natural person until the property is completed. Moreover, such a mechanism would not be justified given that demand is necessarily greater than supply for these types of vacant housing.

Finally, the threshold of equity is well above market practices. The threshold of 35% is identical for all types of operations without considering that the risk incurred by social housing operations is reduced by several mechanisms. In France, for example, the activity of social landlord is very regulated. A control body called the National Agency for the Control of social Housing (ANCOLS) exists to prevent any situation of default and take appropriate recovery measures if necessary. In addition, there is a guarantee fund called Social Housing Guarantee Fund who helps organization in difficulties.

In conclusion, we urge the EBA to review its position on social housing and reduce the threshold defined in the consultation paper.

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