ABI Associazione Bancaria Italiana

ABI POSITION PAPER

on the EBA Consultation Paper on

Draft Guidelines on ADC exposures to residential property

under Article 126a of Regulation (EU) 575/2013

July 2024

General remarks

The Italian Banking Association (ABI) welcomes the opportunity to express its views on the *"Draft Guidelines on ADC exposures to residential property under Article 126a of Regulation (EU) 575/2013"*.

ABI acknowledges the importance of identifying clear rules for the requirements defined in Article 126a (2) of the CRR3 in order to ensure financial institutions apply a risk weight of 100% to ADC exposures, taking into account the simplicity of the Standardised Approach and avoiding unnecessary burdens on the banking industry. Neverthless, ABI would like to point out that the draft Guidelines raise serious concerns regarding the implementation of the envisaged stringent requirements, which could significantly reduce credit for acquisition, development and construction of residential immovable property, with potential negative impacts on the whole EU Residential Real Estate market, and consequently, on the EU economy.

Answers to the most important questions for the Italian Banking Industry can be found below. They are based on the experience of banks in financing the construction sector in Italy.

Answers to the questions for consultation

Question 1: What is the materiality of the pre-sale and pre-lease contracts that would not have the expected characteristics of legally binding contract?
In the context of Italian law, all pre-sale and pre-lease contracts have the expected characteristics of a legally binding contract as defined by the consultation paper.

Question 2: Do you agree with the

pproach proposed to specify the term "substantial cash deposit"?

[no comment]

Question 3: Do you consider the 10% ratio to be appropriate for the determination of the ADC exposures benefitting from the lower risk weight?
ABI considers the 10% ratio for cash desposit to be appropriate. From a prudential perspective, ABI is of the view that this ratio would ensure a satisfactory level of commitment from the prospective buyer to convert the "pre-sale contract" into a "sale contract". It is also in line with the typical practice in Italy.
Anyway, considering the traditional operations in the Italian market, ABI proposes that the level of "substantial cash deposit", requested for pre-lease contracts on the final monthly rent price, should not exceed 100%.

Question 4: Do you have any concerns with applying a single ratio to all ADC projects? Are there any practical options the EBA should consider setting the ratio in a more granular way (e.g., threshold subject to case by case adjustments for either insufficient incentives or for non-enforceability of sufficient incentives but floored at potential market price deterioration over the relevant period) keeping in mind the simplicity of the Standardised Approach and the level playing field across institutions? If yes, please elaborate these options in detail.

[no comment]

Question 5: 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?

[no comment]

Question 6: Are there any other practices that should be considered by the EBA?

[no comment]

Question 7: 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.

[no comment]

Question 8: 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.

[no comment]

Question 9: 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.
Concerning the strict equivalence approach with respect to cash deposit proposed by the consultation paper, ABI proposes to consider that the unfunded credit protection fulfilling the eligibility requirements for credit risk mitigation as specified in Articles 213 and 215 of the CRR could be acceptable, as long as they are granted by banks or other entities under equivalent supervision.

Indeed, ABI believes that those guarantees serve as an equivalence mechanism for the cash deposit since they ensure that: (i) the guarantor pays the seller/owner of the property in case of the termination of the (pre-sale or pre-lease) contract; (ii) the funds paid by the guarantor can later be reclaimed (by the same guarantor) from the buyer or tenant ('recourse right').

Finally, in Italy these guarantees are frequently present expecially for the pre-lease contracts.

Question 10: Do you agree in using two different options for pre-sale/sale and pre-lease/lease contracts?
Please, see answer to Question n.11

Question 11: Do you see any drawbacks related to the proposed options under paragraphs 14 to 16 of these Guidelines?
For the sake of simplicity and ease of interpretation, as an alternative to the proposal in paragraph 14 of the consultation paper it is proposed to adopt a single ratio, based on credit facility, for both pre-sale/sale and pre-lease/lease contracts in order to assess the "significant portion of total contracts" as following:

- **Numerator - the sum of:**

  a. the property value (or sale price as specified in the contracts) of units covered by pre-sale and the property value of pre-lease contracts already signed and in force that met also the threshold set out for the first indicator (i.e. substantial cash deposit) and
  b. the property value of units covered by sale contracts and property value of units covered by lease contracts already signed and in force.

- **Denominator – the total amount of credit facility, including the drawn amount and undrawn amount granted by institutions to the obligor to finance the ADC project related to the residential property.**

We believe EBA credit-facility based approach ensures a more comprehensive and risk sensitive assessment in relation to the amount of the loan granted. As a second best, we propose as the denominator: property value of the entire residential property (currently under development or construction).

The property value mentioned in the proposals would be the value upon completion, assessed by an independent valuer in accordance with Article 229(1) of the CRR.

The 50% ratio is excessively conservative and not in line with typical practice in Italy. ABI proposes a percentage equal to/not higher than 30%.

Question 12: 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?

[no comment]

Question 13: Do you agree with the pros and cons on the different methods explained above? Are there any further issues that the EBA should consider?
Regarding this matter, considering the traditional operations in the Italian market, it is proposed that the level of "substantial cash deposit", requests for pre- lease contracts, on the final monthly rent price should not exceed 100%.

[no comment]

Question 14: Do you agree with the use of method B1 for the aggregation of pre-sale/sale contracts with pre-lease/lease contracts? Can method B1 be applied in practice using option 1 for pre-sale/sale contracts and option 3 for pre-lease/lease contracts? Is it possible to separately identify the amount of the ADC exposure used for financing housing units for sale or for lease ?
ABI does not agree with method B1 proposed in the consultation paper. According to this approach, it is necessary to calculate separate thresholds (one for pre-sale contracts and one for pre-lease contracts) and to satisfy both of them, in order to make banks apply 100% risk weight.

ABI considers that this approach is excessively conservative and risks creating paradoxical effects which do not take into account the material risk of the ADC exposure. For example, in an ADC project with 100 residential units, where 99 units are intended for sale and only one for rental, if the ratio indicated in paragraph 16 for the

property to lease is not achieved, even if the other 99 buildings are all sold or pre-sold, banks could not apply the 100% risk weight to this exposure. Consequently, the entire ADC project exposure would be weighted at 150%, despite all other risk-mitigating conditions for the benefit being achieved.

In other words, this method does not take in account any concept of "prevalence" of the destination of the properties.

Question 15: Are there any other combinations of the options and methods considered by the EBA for aggregating pre-sale/sale contracts and/or pre-lease/lease contracts that are preferable?
Keeping in mind the simplicity of the Standardised Approach also pointed out by EBA in the consultation paper, ABI deems appropriate to define a single ratio in accordance with the approach proposed in Question 11.

Question 16: Which alternative should be considered for assessing whether, for a project where a mixed use is foreseen, the eligible pre-sale/sale and pre-lease/lease contracts are a significant portion of total contracts?
As an alternative to the approach described in Question 11 and 15, as anticipated in the answer to Question 14, ABI proposes to introduce a "prevalence" requirement for projects with properties where a mixed use is foreseen. It should be easily measurable, without imposing additional burdens on banks, taking into account that it should be used in the Standardised Approach.
This requirement should consider the "prevalence" of use of properties, calculated in terms of number of properties destined for sale or lease compared to the total number of units that are part of the ADC project or in terms of the value of the properties (according to the "*property value*" as defined by Article 229 of the CRR and determined by an independent valuer). In this case, in order to apply a risk weight of 100% to the ADC exposure, it should be sufficient to satisfy the requirement of paragraph 14 or 16, according to the main "intended use" of the property (or for sale properties either for lease ones).

Question 17: Do you foresee any practical impediments to include the verification that the developer only has a residual claim on the property in the underwriting standards? How could this "residual claim" feature be ensured in practice in your jurisdiction (e.g., SPV, pledge, mortgages, …)? Please provide reasoning, taking into account market practices and underwriting standards if you think that an adjustment of the EBA's definition of obligor contributed equity is necessary.

[no comment]

Question 18: 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.
The threshold of 35% is excessively conservative and not in line with the typical practice in Italy. The inherent characteristics of the denominator (not embedded within the numerator) do not allow to reach the proposed threshold, with the sole exception of limited and residual number of cases.

Taking into account market practices and underwriting standards, ABI deems appropriate to set a threshold equal to/not higher than 15% for the ratio mentioned in paragraph 19 (i.e. Approach 4).

Question 19: 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?

ABI agrees with the objective that conditions should align with the simplicity of the Standardised Approach and promote ease of interpretation, as emphasised in the Guidelines.
Neverthless, we encourage the adoption of the Approach 4 that seems to be the most consistent with the CRR text and would allow (on the basis of the Guidelines provided in the consultation paper) for a more accurate assessment of the obligor-contributed equity component.
However, if EBA mantains the threshold up to 35%, ABI proposes the adoption of Approach 2 ((Property value upon completion – Total loans)/(Property value upon Completion)). This approach is easy to apply and it contains prudential elements, as the "property value" is determined according to art. 229 CRR, resulting in a value lower than the "market value". Alternatively, ABI proposes Approach 3 ((Total costs of the Project - Total Loans)/(Property Value upon Completion)), which is based on the "construction costs" of the project and is more conservative than Approach 2. Indeed, these "Construction costs" would be estimated according to Valuation Standards such as EVS, IVS and the RICS Red Book, which would ensure a prudent valuation.

Question 20: Do you see any rationale for setting different threshold levels?

[no comment]

Question 21: Do you agree with the adjusted criteria for public housing or not-for-profit entities?

[no comment]