Brussels, 7th August 2024

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EACB comments on
Draft Guidelines
on ADC exposures to residential property under Article 126a of CRR
(EBA/CP/2024/12)

General comments

The EACB welcomes the opportunity to comment on the EBA Draft Guidelines on ADC exposures to residential property under Article 126a of CRR. ADC exposures are a sizeable component of real estate markets across the EU and we appreciate the EBA's efforts to set out a comprehensive approach. We also appreciate the idea to inform the finalization of the draft Guidelines with a QIS assessing the impact of the proposed requirements both in quantitative and qualitative manner.

Despite the general assumption that ADC exposures carry higher risks, we believe it is key to ensure that the historically modest risk profile of these exposures in EU, in light of the specific contractual practices established over time, and risk mitigating factors embedded in national experiences and legislation, is taken into due account.

We see that there are several elements to be better clarified, this is particularly true when looking at the case of non-profit projects.

ADC definition, the move from speculative real estate and the impact on non-profit projects

In this sense it should be noted that the ADC definition replaces the previous definition of speculative real estate financing and is intended to cover real estate financing with increased risk for the financing bank. There is no such increased risk for the financing bank when financing non-profit building associations. Non-profit building associations do not build speculative projects, but urgently needed affordable housing. It is therefore not about vacant vacation homes or apartment complexes, but regularly about affordable housing in urban centers. Most non-profit building associations have very substantial equity and a good credit rating, if only because they are not allowed to distribute profits freely. Insolvencies of non-profit developers are therefore rare. In the past, they have almost only occurred in exceptional individual cases, possibly in connection with criminal activities.

The CRR III recognizes this in principle. It provides for preferential treatment of Income Producing Real Estate (IPRE) in Article124(2)(a)(ii) and para (3) and (4) if it is held by non-profit building associations:

((*ii)* an IPRE exposure shall be treated in accordance with Article 125(1) where the exposure meets any of the following conditions:

(**1**) the immovable property securing the exposure is the obligor's primary residence, either where the immovable property as a whole constitutes a single housing unit or where the immovable property securing the exposure is a housing unit that is a separated part within an immovable property;

(***2***) the exposure is to a natural person and is secured by an income-producing residential housing unit, either where the immovable property as a whole constitutes a single housing unit or where the housing unit is a separated part within the immovable property, and total exposures of the institution to that natural person are not secured by more than four immovable properties, including those which are not residential properties or which do not meet any of the criteria in this point, or separate housing units within immovable properties;

(*3*) the exposure is to associations or cooperatives of natural persons that are regulated by law and solely exist to grant their members the use of a primary residence in the property securing the loans;

(*4*) the exposure is to public housing companies or not-for-profit associations that are regulated by law and exist to serve social purposes and to offer tenants long-term housing;"

<u>Taking this legal background into account one comes to the following conclusion:</u>

- The IPRE exemptions in Article 124(2)(a)(ii) and para 3 and 4 CRR III show very clearly that IPRE exposures to non-profit building associations should receive a low risk weight. However, this intended preferential treatment would not even come into play if the purchase of a property by a non-profit building association for the purpose of constructing a non-profit housing project had to be classified as an ADC. This cannot be the intention of the European legislator (despite the fundamental priority of ADC treatment over IPRE treatment).
- From a legal point of view, a reasonable result is reached that does justice to the actually low risk of non-profit building associations and leaves a scope of application for the preferential treatment of IPRE financing over non-profit developers intended by CRR III if the intention to make a profit (combined with the intention to distribute profits) is interpreted into the concept of real estate development. Real estate development always has something to do with a high proportion of borrowed capital and a borrower's ability to repay depending on the uncertain success of the sale. The use of SPVs is typical. Non-profit building associations are the opposite of SPVs. They are very wealthy and the realization of the affordable housing they create is not a problem at all.
- Against this background, it was misleading that in the last negotiations the EBA mandate in Art 126a CRR III was also extended to include a mandate to the EBA to take into account 'the specificities of institutions' lending to public housing or not-for profit entities across the Union that are regulated by law and that exist to serve social purposes and to offer tenants long-term housing" in the guidelines on the undefined legal terms used in Article 126a CRR III. The specificities of not-for-profit entities should not be taken into account by calibrating any thresholds differently. Rather, it is a matter of clarifying that the financing of non-profit building associations does not generally fall under the scope of ADC, as this is the only way to leave room for the application of the preferential treatment corresponding to the actual low risk in accordance with Article 124(2)(a)(ii) and para 3 and 4 CRR III.
- We also believe that treating exposures to not-for-profit entities as ADC exposures under Article 126(2) CRR3 is an inconsistent implementation of the final Basel III standards (BCBS 424) into EU law. Paragraph 68 of BCBS 424 explicitly states that public housing companies and not-for-profit associations should generally be excluded from the IPRE treatment, irrespective of the property's completion status. Instead, the loan-splitting or ETV approach should be applied. Given that not-for-profit entities are excluded from the IPRE treatment even during the construction phase, this rationale should be even more applicable to the stricter ADC treatment. In our view, BCBS 424 does not intend for exposures to not-for-profit entities to be classified as ADC exposures. Therefore, they should not be treated as such under CRR3.

- Moreover, we would like to draw the attention to the draft rules for the **Basel IV implementation in the United States**. **Para. 1831bb** stipulates capital requirements for certain acquisition, development, or construction loans ('HVCRE ADC loans'). HVCRE loans can be compared with ADC exposures pursuant to Article 126a CRR. According to Article 1831bb para. 2 a non-HVCRE ADC loan does not include a credit facility financing. In particular, we would like to refer to (POINT D) which states as follows:

(D) commercial real property projects in which —

> *(i) the **loan-to-value ratio is less than or equal to the applicable maximum supervisory loan-to-value ratio** as determined by the appropriate Federal banking agency;*
> *(ii) the borrower has contributed capital of at **least 15 percent of the real property's appraised**, ''as completed'' value to the project*

- In this context, para. 365.2 of the US Basel IV implementation draft (Real estate lending standards) provides Supervisory Loan-to-Value Limits as follows (80 % LTV for Construction):

Supervisory Loan-to-Value Limits

Institutions should establish their own internal loan-to-value limits for real estate loans. These internal limits should not exceed the following supervisory limits:

Expand Table

Loan category	Loan-to-value limit (percent)
Raw land	65
Land development	75
Construction:	
Commercial, multifamily,[2] and other nonresidential	80
1- to 4-family residential	85
Improved property	85
Owner-occupied 1- to 4-family and home equity	([3])

[2] Multifamily construction includes condominiums and cooperatives.

[3] A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied, 1- to 4-family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

- Comparing the prospective US rule to the CRR3, it is evident how the envisaged approach would entail a substantial competitive disadvantage for European banks in comparison to the US institutions. This outcome should instead be avoided as the EU aims to stimulate investment and competitiveness. These targets were also recently stipulated by Commission President von der Leyen in her Political Guidelines, and we believe that they should also inform the policy choices when it comes to these technical aspects.

<u>Answers to selected questions</u>

Q1: What is the materiality of the pre-sale and pre-lease contracts that would not have the expected characteristics of legally binding contract?

With regards to pre-sale vs. sale contracts, we notice that pre-sale contracts are defined in such a way that cancellation by the buyer is accepted. At the same time, it is required that the deposit paid is forfeited if the buyer cancels the contract. However, this puts pre-sale and purchase contracts on an equal footing, as at least part of the cash deposit is forfeited in both cases. The purpose of this distinction is unclear and should be substantiated.

It should also be noted that institutions may have different practices entirely, and some may not accept pre-contracts as proof of sale or lease.

Regarding properties for sale and rent, it is not evident whether the key figures for the sales and leasing rates are to be determined separately (with the respective allocation of the relevant residential units to the form of realisation) if there is a mixed realisation of the property (both leasing and sales). We encourage the EBA to clarify this.

With regard to the legally binding nature of sales or rental agreements, we believe this is the case if there are concurring declarations of intent (offer and acceptance) regarding performance and consideration (in particular the object of purchase or rental as well as the purchase price and amount of rent). Statutory or customary contractual termination options as well as statutory warranty claims should not be detrimental to legal validity within the meaning of Art 126a (2) CRR III.

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

In several Member States, it is common for dwellings to be sold prior to the start of construction on a property project. For this purpose, bank guarantees or irrevocable payment guarantees are issued by the buyer's bank and deposited with a trustee to secure the sale price of the residential unit.

Due to the structure of the bank guarantee (abstract, can be drawn without objection at first request, bank as guarantor), it can be regarded as equivalent to a cash deposit. We believe that these bank guarantees or irrevocable payment guarantees from the buyer's bank should be regarded as a 'cash deposit', we would appreciate a clarification from the EBA in this regard.

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

NA

Q4: 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.

Any alternative to set the ratio in a more granular manner should keep in mind the inherent simplicity of the Standardised Approach and the level playing field across institutions.

In addition, however, in our view once the building is completed (notification of completion), it would no longer be an ADC, but an IPRE (thus application of ETV or loan-splitting is possible). It is not necessary for the apartments to have already been let or sold or for a certain ratio to have been reached.

It follows from the definition of IPRE that the fulfillment of the loan obligations is essentially dependent on the cash flows generated by the properties securing this risk position, rather than on the debtor's ability to fulfill the loan obligations from other sources, whereby the primary source of such cash flows are rental or lease payments or proceeds from the sale of the residential or commercial property.

However, the fact that the fulfillment of the loan obligations is largely dependent on the cash flows generated by the properties securing this risk position does not mean that the cash flows for the proper fulfillment of the loan obligation are already secure/secured (rental or sale already completed). ADC financing finances the acquisition of land for development and construction purposes or the development and construction of residential or commercial properties. Once the land acquisition, development and construction have been completed, the purpose of the financing has been achieved and the uncertainty from the perspective of the secured bank is considerably reduced, as the pledged property has already been completed and can therefore be sold).

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?

This form of security (deposit of 3 months during the construction phase for residential property) is not provided on certain national markets, in those cases the expectations do not seem applicable to the national situation (e.g. in Austria).

Q6: Are there any other practices that should be considered by the EBA?

In the sector of non-profit housing, only the expected rent can be quoted at the time the pre-letting agreement is concluded, as non-profit organisations operate on a cost-covering basis and it is not yet possible to definitively define how high the final construction costs will be during the construction phase.

It would be useful to clarify that the expected rent can be used as a parameter for determining the quota.

Please see also our comments in the opening section and under Q21.

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.

Any alternative to set the threshold in a more granular manner should keep in mind the inherent simplicity of the Standardised Approach and the level playing field across institutions.

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.

NA

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.

NA

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

NA

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

According to the current proposal, residential units of different sizes that are rented out are considered of equal value. This means that a 50m² and a 150m² flat are to be considered to the same extent, although their values (and rents) differ significantly. If the quota were based, for example, on the ratio of rented living space to rentable living space, the quota could be more balanced.

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?

NA

Q13: Do you agree with the pros and cons on the different methods explained above? Are there any further issues that the EBA should consider?

NA

Q14: 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 ?

NA

Q15: 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?

NA

Q16: 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?

Based on the example provided of method B1, it can be concluded that a worse position is achieved if a mixed realisation of the property is sought (sale and lease), as in these cases both key figures must reach the ratio of 50%. According to the example, the risk weighting of 100% should only be applied if a tenant is found for the only flat to be let, although all other flats have already been sold.

We therefore recommend that the quotas should continue to be determined separately, but that they should be aggregated so that they are equalised with projects that are either sold or rented out. This approach would also simplify the calculation of the quota and thus make it less prone to errors.

Q17: 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.

NA

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.

A rate of 35% for non-profit housing construction appears excessive due to the rather low risk situation. The companies involved are subject to stricter regulations (e.g. in Austria the WGG, Wohnungsgemeinnützigkeitsgesetz). Projects are built by an established company and not by a special purpose vehicle. In addition, the equity capitalisation of these established companies is not comparable with commercially active companies. The realisation of profits is not at the centre of these companies, whereby profits achieved may only be paid out to an extremely limited extent. In addition, the ownership structure, which typically includes associations, private foundations, church investors, banks and insurance companies, differs significantly from commercial investors. It would be more appropriate for the equity contributed by the debtor to be set in relation to the total investment costs.

We also see that the financing contribution to be deposited by future tenants (according to national law, e.g. the WGG) could be interpreted as a ‘cash deposit’. Financing contributions do not expire if the future tenant withdraws from the tenancy agreement. Moreover, the financing contribution is often amortised on a straight-line (e.g. in Austria over 100 years, i.e. 1% per year). If the tenant cancels the lease, the GBV (Gemeinnützige Bauvereinigung) returns the remaining financing contribution calculated in this way.

The proposed thresholds are generally overly cautious in view of the low default rates for residential real estate projects. The EBA's approach of setting the criteria of Art 126a in such a way that they are not reached by current market practice (cf. e.g. openly stated in the explanatory text to paragraph 16: ‘*With respect to the 50% threshold level, it has been calibrated such that it exceeds the current market practices, in order to justify the significant lowering of the own funds requirements.*’) is punitive and should be reconsidered. This approach would read as if it were a special concession that a residential construction financing secured by real estate receives a risk weighting of 100%. The opposite is the case. Reputable residential construction financing must continuously be possible and the market standard is a reputable benchmark. In contrast, the approach in the consultation paper would make lending unnecessarily more expensive and further stifle the already sluggish construction sector. It would be sufficient to require only 25% equity instead of the 35%, as projects are usually calculated with a profit margin of around 10%, so that a buffer of 35% of the value of the property is available for loan repayment after completion anyway.

What is also missing is a consideration of the fact that an appropriate equity share, which would not be sufficient on its own to justify a risk weighting of 100%, can very well justify such a lower risk weighting in combination with an acceptable degree of pre-utilization. A risk weighting of 100% should also be possible with an equity ratio of more than 20% and a pre-realization ratio of more than 40%.

In addition, the amount of the quota also depends on which components may be used. According to paragraphs 18 and 19, this includes various components. It would be useful to clarify the following aspects, in order to achieve a better understanding of the proposed approach:

- How is evidence to be provided regarding information on subsidies already invested?

- Do subsidies and grants mentioned in point b of paragraph 19 encompass provided state aid (such as subsidies from state or regional governments)? If they do, is the legally binding grant assurance sufficient to be considered as already invested obligor-contributed equity?
- Are subsidies exclusively those that do not need to be repaid, or can interest-subsidised loans from the state and local authorities also be included?
- What requirements must readily marketable assets fulfil for an asset to be considered directly related to the project and readily marketable?
- According to our interpretation, 'land' owned by the debtor can be included. Can other real estate provided by the debtor as collateral also be included in the calculation of the debtor's contributed equity if it is unencumbered?

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?

A practical alternative would be using "total invested capital" as the denominator instead of the "property value upon completion".

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

See answer to Q18.

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

See also answers to Q6 and Q18.

The adjusted criteria for not-for-profit entities remain too strict. Paragraph 20 of the EBA-GL is too narrow when it states:

ADC exposures to public housing or not-for profit entities across the Union that are regulated by law and that exist to serve social purposes and to offer tenants long-term housing should be subject to the treatment referred to in paragraph 21 where both of the following conditions are met:

a) The intended use of the property is exclusively for lease;

b) The property being financed is subject to a regulation specifying the eligibility to qualify for social/public housing, including criteria for applicants in relation to their income, their family size, their residency status, and requirements for the construction, including the size of each unit or being barrier-free.

Point a would exclude – for example – numerous Austrian building associations from treatment under Article 126a: The Austrian Non-Profit Housing Act also permits the initial sale of apartments to members of non-profit building associations (cf. Section 7 (1) and (1a) Austrian Limited Profit Housing Act – Wohnungsgemeinnützigkeitsgesetz, WGG). Many building associations make use of this because it is the quickest form of refinancing and enables them to create new living space sooner. In addition, there is also a legal option for tenants to receive a purchase offer after 5 years in the case of pure rental projects under certain conditions (see Article 15b et subseq WGG). The fact that this is nevertheless "exclusively for lease" should be made clear.

Point b lists far too many individual criteria without making it clear that these are only examples of the type of criteria that must be met in order to fall under the preferential treatment. It would be completely inappropriate to exclude the financing of a building association simply because, for example, there are no rules in a Member State on the minimum size of the family that is to move into the apartment built by the non-profit building association.

In Paragraph 21, it is proposed that the minimum number of binding contracts that must be present should be 75% instead of the usual 50% (paragraph 13) - cf

“Significant portion of total contracts": for the portion of total contracts to be considered as being significant, the percentage referred to in paragraph 13, calculated in accordance with paragraph 16, should be equal to or higher than 75%.

This approach does not appear justified. Just because non-profit building associations have no problem selling their affordable housing does not mean that a higher threshold has to be set. This has nothing to do with the low risk for the financing bank and also does not suit the sometimes socially disadvantaged clientele of non-profit building associations who would particularly suffer if their down payment were to be forfeited.

Among Member States, in Austria, for example, not-for-profit entities typically operate with preregistration lists during the construction phase and later rely on both their own marketing activities and state allocation programs. Due to the high demand for affordable rent and the necessity of grant assurance for marketing (which often arrives late in the construction phase), marketing of these projects usually begins just before construction is completed. Consequently, the phase with lower risk-weight is likely very short and, given the long duration of the loans (up to 40 years), negligible for both the bank and the not-for-profit entity.

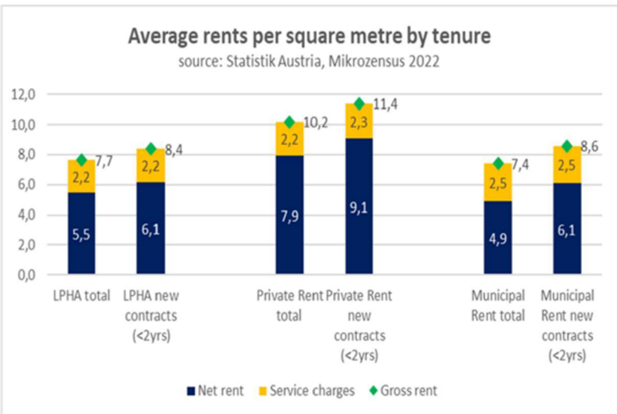
The exposures towards Not-for-profit housing associations (i.e. long-term rental housing loans, often subsidized by the State) are therefore among those with the lowest risk profiles, even in the ADC phase of a project.

This has to do with various factors:

a) the experience for decades in the development business,

b) specific national legal obligations to be e.g. supervised both by state authorities as well as by an independent audit organization,

c) the fact that the rents of their apartments are approx. 20-25% lower than market rents and therefore the average vacancy rates are below 2% (which is merely a technical vacancy due to tenants’ changes). Therefore, there is only a very low risk of not renting out the apartments produced by not-for profit housing associations. (see the graphic below that shows that Low-Profit Housing Associations’ = LPHA’s rents are approx. 25% below private rents).



- Since not-for profit entities are 'regulated by (national) law' and therefore the differences in the single not-for profit housing associations systems can be relevant from country to country, the EBA should rather leave to the national supervision authorities to establish the requisites for a preferential treatment at national level or apply a high-level principle-based approach.
- Such a regulation could e.g. define that "financing ensured in an equivalent manner" to not-for profit housing associations is given in case their rents / selling prices are at least 20% below market prices.

In the light of all these relevant circumstances, we rather suggest a general and unconditional ADC risk-weight of 100% (instead of 150%) for not-for-profit entities during the whole construction phase, especially for state-subsidized projects of not-for-profit entities because these projects are not comparable to standard real estate projects (in SPVs).

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