Comments

EBA Consultation on draft Guidelines on ADC exposures to residential property under CRR 3

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks.

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Overview of Questions

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

In Germany, the financing of residential developments for (individual) sale is regularly based on binding, notarized sale contracts while pre-letting is basically not existing in residential developments. The German MaBV-regulation ("Verordnung über die Pflichten der Immobilienmakler, Darlehensvermittler, Bauträger, Baubetreuer und Wohnimmobilienverwalter (Makler- und Bauträgerverordnung - MaBV)") ensures the ultimate payment of the purchase price according to a respective payment schedule, whereas down payments for purchase contracts are not permitted by law. Thus, we appreciate the clarification that the requirement of cash deposits or equivalent prerequisites only apply in case of pre-sale/ pre-lease contracts.

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

NA

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.

NA

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?

NA

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

NA

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.

NA

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?

Option 1 'credit facility based' is appropriate for sales contracts.

In Germany, leases are only granted after completion. Therefore, the proposed metric for pre-lease/ lease contracts would not work in the first place. Hence, it is no viable option for a harmonised treatment throughout Europe. In practice, the decisive determinant of the actual risk is the situation on the rental market. For instance, the current housing shortage minimises the likelihood of entities remaining unlet – irrespective of the presence of pre-lease contracts. In other words, if the vacancy rate for flats in a definable rental market does not exceed 5%, it can be assumed that the required occupancy rate will be achieved within a short period of time after completion if new contract rents are calculated at the usual local rate. The requirement in Art. 126a (2) (a) CRR should therefore be deemed to have been met. Alternatively, GBIC's market fluctuation concept with the percentage changes in prices for apartment buildings in the last one to three years could be used to prove that a stable letting market exists.

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

From our perspective, Option 1 is the most reasonable approach and therefore our clear preference. However, the ratio of 50% is way too conservative. It is above current market practice and internal risk policies. It is not appropriate for the threshold to be calibrated in such a way that it exceeds current standard market practice. Rather, only those financings that are riskier than standard market practice in the EU should be affected by the high risk weight of 150%. In line with this, we suggest a threshold of around 30%.

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?

To begin with, we ask for clarification that the additional guidance foreseen in Para. 17 only addresses situations in which one credit facility covers both entities for sale and for rent ("mixed-use credit facilities"). In cases of separate credit facilities, no additional questions arise in the first place, even if they refer to the same overarching development project ("mixed-used developments").

That being said, we acknowledge the EBA analysing potential, specific solutions for mixed-use credit facilities. However, we would like to note that the consultation paper explores very detailed and small-scale specifications. From our point of view, the actual mandate in Art. 126a CRR III does not require the EBA to provide explicit guidance at such granular level.

If additional guidance was still deemed necessary, it should at least remain flexible. In particular, the application of a pro-rata approach should not be completely excluded from the outset.

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?

NA

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.

We consider the proposed equity contribution of 35% as exaggerated. In fact, equity contributions of 10% to 30% of total investment cost prevail in the market. Taking into account actual price fluctuations in recent decades, covering discounts of 20% or 30% seems perfectly adequate. Even in the current crisis, the price discount did not exceed 20%. Moreover, it should be taken into account, that, in practice, sale contracts have an additional risk mitigating effect beyond equity contributions. Accordingly, the threshold should not be higher than 20%.

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?

In our view, all proposed approaches have one important shortcoming. They fail to take into account certain effective and commonly used risk mitigating measures. Irrespective of the specific approach, we strongly recommend allowing for the consideration of all valuable and liquid assets that serve as collateral (in particular recourse/cash, guarantees, assessable land charge on other properties) as a source of equity. Appropriate levels of conservatism can still be ensured by applying common criteria on the value and realisation, e.g. a certain minimum credit worthiness of a guarantor. Completely discarding frequently used equity-equivalent risk mitigants would violate the level playing field among institutions and create counterproductive incentives.

Moreover, the level 1 text contains a conceptual flaw in our opinion. In practice, banks use the ratio of the loan amount versus and the total investment cost as key indicator. Instead using the property value upon completion as reference, as explicitly stated in the level 1 text, will lead to problems. As the profitability of a project (i.e. the difference between total costs and eventual property value) increases, the likelihood of falling below the respective equity threshold increases as well. Consequently, the current proposal is too restrictive in our view.

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

With regard to the "Significant portion of total contracts" (50%)

- We suggest a threshold of 30% (c.f. Q 11)

With regard to the "Amount of obligor-contributed equity" (35%)

- We suggest a threshold of no more than 20% and widening the perimeter of eligible collateral (c.f. Q 18)

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

No, generally, one would expect rather lower regulatory requirements for exposures towards public housing / not-for-profit entities. While this seems to be the case for condition a. (substantial cash deposit), the contrary holds true for conditions b. and c. Here, too, the proposal cannot be applied in Germany, as we do not have any pre-lease/lease contracts before completion. From our point of view, the intention of the project and the obligation to comply with statutory regulations should be sufficient to justify the 100 % risk weight.