19 August 2024

**EBA consultation on**

**Draft Guidelines on ADC exposures to residential property**

**Comments of the Austrian Banking Industry**

**General remarks**

There are several elements in the Guidelines which need to be clarified, in particular with regards to non-profit projects.

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, because they are not allowed to distribute profits freely. Insolvencies of non-profit developers are therefore rare. In the past, dating back more than 30 years, they have almost only occurred in exceptional individual cases, 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;”**

**Taking this legal background into account one comes to the following conclusion:**

* 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 IPRS 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 (either for rent or for sale) 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 incorrect 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.

**In the event that the EBA – despite of all the substantive arguments – is unable to come to a general clarification of the non-application of the ADC rules to the financing of non-profit building associations, we would like to comment on the proposed details:**

First of all, we would like to raise attention to the **Basel IV implementation draft in the United States**. **§ 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, § 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):



Comparing the envisaged US implementation to the European, anyone can realize the massive competitive disadvantage for European banks in comparison to US institutions.

**Competitive drawbacks for EU banks should be avoided by any means.** This clear target was also recently stipulated by President von der Leyen. This approach should be duly taken into account by EBA.

**Questions**

**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?**

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| Since the Bauträgervertragsgesetz (the Austrian Law regulating the drawing plan and securisation of disbursements according to the construction progress) regulates certain withdrawal rights for the buyers without a fee or other compensation for the developer, all development projects would be subject to this regulation. * Therefore, a clarification “legally binding, except mandatory withdrawal rights of the buyer” would be helpful.

According to our understanding, a preliminary contract is an agreement to conclude the main contract (purchase contract or rental agreement) in the future. The obligation arising from the preliminary agreement therefore includes the conclusion of a purchase or rental agreement. Pre-sale and pre-lease agreements are therefore of minor practical significance for real estate financing. In connection with Article 126a (2) CRR III, a lot of banks plan not to accept pre-contracts as proof of sale or lease (as has already been the case in connection with speculative real estate financing), but only the submission of written (and thus legally effective) sales or lease agreements concluded on the basis of concordant declarations of intent (offer and acceptance).Legally binding nature of sales or rental agreementsAccording to the draft EBA-GL, the pre-sale and pre-lease agreements and sale or lease agreements must be legally binding (however, the draft EBA-GL only regulates when pre-sale or pre-lease agreements can be considered legally binding, namely when they are concluded in writing, the latest time/date for signing the sale/lease agreement and the purchase price/rent, must include any conditions under which the potential buyer/tenant can still terminate the preliminary agreement instead of signing the sale/lease agreement, unless this right of the buyer/tenant cannot be excluded by law);We assume that sales or rental agreements - in accordance with general legal principles - are legally binding if they have been concluded with legal effect. In our view, 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. |

**Question 2: Do you agree with the approach proposed to specify the term “substantial cash deposit”?**

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| Yes. On the Austrian market, 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. Therefore, we ask EBA to confirm that these bank guarantees or irrevocable payment guarantees from the buyer's bank can be regarded as a ‘cash deposit’. |

**Question 3: Do you consider the 10% ratio to be appropriate for the determination of the ADC exposures benefitting from the lower risk weight?**

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| At the moment, there are no penalties in Austria, except the compensation of the developer for proven expenses (see answer to question 1), since the price is paid in several steps depending on the progress of construction (as a consuer protection measure in case of insolvency of the developer). |

**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.**

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| We have no concerns. 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 our view once the building is completed (notification of completion), there is no longer 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). |

**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?**

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| This form of security (deposit of 3 months during the construction phase for residential property) is not provided on the free Austrian market, so the proposed regulation is not applicable to Austria in our view. |

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

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| In 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. EBA should confirm (systematically in the part covering non-profit housing) that the expected rent can be used as a parameter for determining the quota. |

**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.**

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**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.**

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**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.**

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| Art 126a para 3 regulates that EBA should specify, inter alia, the term “financing ensured in an equivalent manner”. In the draft guidelines, every single possibility of an equivalent to cash is excluded, thus making it impossible to use any other means of security. * At least guarantees issued by banks and other institutions that have a certain credit rating (e.g. investment grade) should be admitted.
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**Question 10: Do you agree in using two different options for pre-sale/sale and pre-lease/lease contracts?**

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**Question 11: Do you see any drawbacks related to the proposed options under paragraphs 14 to 16 of these Guidelines?**

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| The pre-sales resp. pre-rent quota of 50% is far above actual market standards and policies as adopted by the respective supervisory authorities. In Austria, a quota of 30% is the market standard.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.In relation to the significant portion of total contracts under Article 126a(2)(a) CRR: legally binding pre-sale and sale contracts and legally binding pre-lease and lease contracts will be considered a significant portion of total contracts if they represent a percentage of 50% or more of total contracts. According to the EBA GL draft, the percentage of 50% for purchase contracts should be calculated as the sum of the sales prices divided by the total amount of the credit facility, including the drawn and undrawn amount. This is generally understandable for us.In the case of rental agreements, however, we would like to propose an amendment (regarding the calculation of the significant proportion of total agreements): according to the EBA GL draft, the percentage of 50% for rental agreements should be calculated as the sum of the number of legally binding rental agreements divided by the total number of units that are part of the ADC project related to the residential property. We consider it appropriate for the percentage to be calculated by dividing the area already let (on the basis of legally binding rental agreements) by the total lettable area of the residential property. |

**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?**

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| Normally, there is 1 credit contract for the sales part (term: 3-5 years), and another credit contract for the leasing part (term: up to 30 years), therefore the 2 areas can be treated separately. |

**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?**

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| See answer to question 12In addition: Based on your example 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. |

**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 ?**

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| See answer to question 12In addition: Can method B1 be applied in practice using option 1 for pre-sale/sale contracts and option 3 for pre-letting/letting contracts? Is it possible to separately determine the amount of ADC receivable used to finance residential units intended for sale or for rent? |

**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?**

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| See answer to question 12 |

**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?**

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| See answer to question 12 |

**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.**

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| One of the possibilities of “obligor contributes equity” is subsidies. At the time of granting a loan, often these subsidies are not paid out (because they depend on the construction progress), but they are granted by the subsidy authority.* Therefore, the legally binding granting act of the respective authority should be sufficient to be accepted as equity.
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**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.**

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| 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 to be rejected. This justification reads 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 reputable. 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 quite 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. We request clarification of the following questions:- How is evidence to be provided that gives information on subsidies already invested? - Are subsidies exclusively subsidies 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? |

**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?**

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

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| The proposed regulation that the privileged RWA of 100% can be applied also subsequently according to the number of (pre)-sales contracts should be applied also to a possible increase of (pre-)rent contracts and contributed equity as well.Also please see answer to question 18.  |

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

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| Art 126a para 3 provides for “taking into account the specificities“ of the mentioned entities, referring to all of the terms that are specified in these draft guidelines. In the draft, however, only the terms regarding (pre-)rental contracts are specified, leaving unspecified the term “appropriate amount of obligor-contributed equity” which is a clear task assigned by the legislator.* Therefore, we urge to specify also the term “appropriate amount of obligor-contributed equity” for public housing resp. not-for-profit entities.
* A equity ratio of 15% should be sufficient, reflecting the very low risk profile of these developers, as compared to market-driven development companies.

Moreover, the proposed “significant number of legally binding contracts” should be defined in another way, because at the time of granting a loan (i.a. 2-3 years prior to completion of the building), no binding rental contracts are concluded. (They are concluded in the 6 months prior to completion). * Therefore, waiting lists without penalties should be sufficient, since no binding (pre)contracts exist at the time of granting the loan.
	1. The adjusted criteria for not-for-profit entities remain too strict. Paragraph 20 of the EBA-GL is clearly too narrow when it states:
	2. 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:
	3. a) The intended use of the property is exclusively for lease;
	4. 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 this 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 is completely incomprehensible. 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.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.In the Austrian bank’s risk profiles, the exposures towards Not-for-profit housing associations (i.e. long-term rental housing loans, often subsidized by the State) are one of the exposures with the lowest risk profiles, even in the ADC phase of a project. This has to do with 1. their experience for decades in the development business,
2. their legal obligation to be supervised both by state authorities as well as by an independent audit organization and
3. Ein Bild, das Text, Screenshot, Schrift, Diagramm enthält.  Automatisch generierte Beschreibungmainly 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 quite big from country to country, EBA should give a sub-mandate to the national supervision authorities to regulate the requisites for a preferential treatment on national level
* 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).A rate of 35% for non-profit housing construction appears excessive in Austria due to the lower risk situation: The companies involved are subject to stricter regulations (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.**Questions that cannot be assigned:**- **Pre-sale vs. sale contracts**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. Why the distinction?- **Properties for sale and rent**Are the key figures for the sales and leasing rates 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)?- **Non-profit housing** Can the financing contribution to be deposited by future tenants (pursuant to WGG) be interpreted as a ‘cash deposit’ pursuant to EBA? Note: Financing contributions do not expire if the future tenant withdraws from the tenancy agreement. Additional information: the financing contribution is amortised on a straight-line basis 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. |