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Finance for Europe

Association for Financial Markets in Europe

AFME response to EBA consultation paper on Draft Regulatory Technical Standards on equivalent mechanism for unfinished property under Article 124(12) of EU Regulation 575/2013

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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

CP RTS on equivalent mechanism Art.124-12.pdf (europa.eu)

Section 4 : Garanties financières d'achèvement et de remboursement (Articles R261-17 à R261-24-1) - Légifrance (legifrance.gouv.fr)

Through CRR Article 124, banks should be able to benefit from the possibility to consider unfinished residential property as eligible collateral for the purpose of RWA computation.

For properties in construction related to an ADC program, the CRR allows for the recognition of such properties as eligible collateral when their completion is insured by a sovereign entity or similar. This type of scheme is at the best very unusual, not to say unknown to banks. The EBA mandate aiming at clarifying what is an equivalent legal mechanism to the above and allowing for unfinished collateral recognition is therefore highly welcomed by banks. This is especially true in the context of the recent difficulties encountered by real estate developers across Europe.

Nevertheless, within its mandate, the EBA has defined as equivalent mechanisms only those mechanisms whereby the completion guarantee is not provided by a sovereign entity or alike but counter-guaranteed by the latter. Again, this situation is unknown to banks which means that this EBA position would leave the EBA mandate without having any effect.

We therefore urge the EBA to reconsider its alternative approach - that is to recognize a completion guarantee provided by financial sector entities when they are mandatory by law as a legally equivalent mechanism. Indeed, we want to recall that the drawing on such financing is contingent to the achievement of a tranche of work and will be made available to the client only upon the related capital call presentations. In light of the completion guarantee mechanism which gives high degree of certainty to a secondary buyer, the unfinished property can be disposed for a value reflecting its stage of completion in a standard way.

Therefore, if a client should default prior to the immovable property completion, the outstanding amount of its loan will be fully secured by the unfinished property value. Ignoring the consequences of this legal mechanism will unduly force the non-consideration of any security on the amount owed to banks.

When it comes to the undrawn part, this would also go against the substance of CRR Article 193(7): "*Collateral that satisfies all eligibility requirements set out in this Chapter can be recognised even for exposures associated with undrawn facilities, where drawing under the facility is conditional on the prior or simultaneous purchase or reception of collateral to the extent of the institution's interest in the collateral once the facility is drawn, such that the institution does not have any interest in the collateral to the extent the facility is not drawn.'*; indeed when the facility is drawn, it is to pay for the achievement of a tranche of works which translates into an additional value of collateral in which the bank has interest.

When we acknowledge in our response the necessity to have some safeguards to ensure the robustness of such a completion scheme (such as minimum credit quality for the protection provider or capital requirements conditions), we are of the opinion that the alternative approach should be further adapted to make it applicable, notably considering the below:

- Given the specificity of a by-law completion guarantee, which takes rather the form of a "cautionnement"/performance bond whose activation is contingent to both the financial discrepancy of the real estate developer and its failure in its contractual duty to complete the building, the eligibility criteria contemplated by the EBA cannot be exactly the same as the ones applicable in the context of a credit protection recognition.
- The alternative approach relies on the RW substitution under the standardized approach: the EBA mandate is limited to the specification of what an equivalent legal mechanism is, without any provision for changing the CRR risk-weighting method
- The preclusion of completion guarantee providers belonging to the same group as the lending entity is an over penalizing provision leading to RWA double-counting – note this is a common practice for multi-activities banks to grant the completion guarantee while another business finance the mortgage loan.

We have provided further details of relevant schemes across EU jurisdictions in Annex A.

Q1(a): Are there some practical cases where a central government, regional government or local authority or a public sector entity involved, exposures to which are treated in accordance with Articles 115(2) and 116(4) of the CRR, respectively, has the legal powers and ability to ensure that the property under construction will be finished within a reasonable time frame and is required to or has committed in a legally binding manner to do so where the construction would otherwise not be finished within a reasonable time frame (i.e. existence of cases referred to in Article 124(3)(a)(iii) of the CRR)? In the context of Q1(a), please describe in detail the sources of the legal powers and the ability of central government, regional government or local authority or a public sector entity as well as the arrangements regarding the requirement or the commitment to finish the construction in a reasonable timeframe.

If such cases should exist, they are clearly very remote ones.

Q1(b): Are there some practical cases where legal powers and ability to ensure that the property under construction will be finished within a reasonable time frame is given to an entity that is neither a central government, nor an entity for which exposures are treated in accordance with Articles 115(2) or 116(4) of

the CRR (i.e. existence of cases referred to in the current Article 1 of the RTS)? In the context of Q1(b), please describe in detail the sources of the legal powers and the ability of this entity as well as the arrangements regarding the requirement or the commitment to finish the construction in a reasonable timeframe.

In several European jurisdictions (France, Belgium, Luxembourg) where the completion guarantee is mandatory by law, eligible providers are only financial sector entities (e.g. banks, insurers, guarantee firm) without any counter-guarantees requirement. Such market reality makes the EBA proposal of Article 1, as a pure extension of a very remote case where the construction finalization might be insured by a sovereign or alike counterparty, simply non-applicable. We are therefore of the opinion that the EBA should strongly reconsider its contemplated alternative approach in the finalization of the RTS. This alternative approach should be further improved as described later in our response.

Q2: With regard to subparagraph (d)(iii)(first indent) above, could you provide insights into how pledging the rights under the completion guarantee functions from both a legal and practical perspective? Specifically, in current market practices, are the rights pledged only upon the default of the obligor? If so, are any measures being considered or implemented to mitigate the legal risks associated with the pledge potentially needing to be upheld by the insolvency administrator under applicable insolvency law, and at last to ensure effective protection of the institution's interests?

There is no direct ex-ante pledge of the completion rights at origination or in case of default. However two situations may be identified in the case of the default of the obligor prior to completion[1] through the mortgage activation:

i) either the bank repossesses the immovable property and manages to have a sale executed: in this situation, until the sale, the client remains the owner of the property and the beneficiary of the completion guarantee in case of failure of the developer; any capital call occurring after default (due to works achieved by the developer or by completion guarantee activation) and before the sale would be financed through an additional drawing on the loan and the collateral potential sale price would have increased accordingly; through the mortgage lien the bank can claim for sale proceeds up to the mortgage referenced value (usually the loan total authorization) and would therefore benefit from any additional value reflected in the price due to any kind of completion achieved after default.

ii) or the bank repossesses the immovable property and eventually becomes the owner of the property: the completion right is attached to the property and can only benefit to its owner. Hence, in this case the bank fully becomes the owner of the property for a value reflecting its stage of completion and at the same time the beneficiary of the completion guarantee. The bank will thereby benefit from the same protection in case of failure of the developer up until the point it manages to dispose of the property, which is therefore facilitated.

This way of operation makes this eligibility criteria *(d)(iii)(first indent)* unnecessary for the recognition of an equivalent legal mechanism in the form of completion guarantee since its effect on the banks' interests are already addressed by the legal certainty requirements to be met for immovable property collateral recognition (CRR Article 208(2)) or through proper transfer of ownership.

[1] We want to recall here that the outstanding amount of the loan upon default reflects the state of completion of the property thus the collateral value

Q3: Could you provide the RW of the entities that are currently protection providers for such completion guarantees, as well as the type of counterparty (i.e. financial institution, other financial sector entity or corporate)?

As stated in our response to Q1, the completion guarantee providers are financial sectors entities, mainly banks and insurers.

In the case of insurers, they belong to the corporate exposure class for which a 20% RW corresponds to a CQS1 - [AAA/AA] rating under the standardized approach. Banks belong to the institution exposure class for which a 20% RW corresponds to a CQS1 - [AAA/AA] rating too. Hence, very few European banks or insurers would benefit from a 20% RW following the CRR Article138 conservative rules of selection of an external rating among multiple external ratings.

Note that this does not even consider the provision of CRR3 Article 113 regarding the due diligence on external rating that may lead to higher risk-weighting.

We understand that the EBA considers that a 20% RW is relevant by reasoning through a substitution approach whereby there would be no distortion versus the Loan Splitting RW applicable to the part of an exposure secured by a finished property. When we acknowledge the necessity of having safeguards in relation to the capital requirements to which the protection provider is subject as well as in regards of its credit quality (for instance a minimum CQS of 2 or, for unrated institutions, qualifying for Grade A under SCRA), we are of the opinion that the 20% RW is far too conservative and would disqualify many protection providers in order to benefit from the CRR treatment. We are also not supportive of the alternative substitution approach on the part of the exposure secured by the immovable property, given that this would consist in risk-weighting this part with the protection provider RW.

Indeed, we want here to recall that:

- Completion guarantees are rather performance bonds (since also contingent to the failure of the developer in its duty in regards of the construction achievement) not pure financial guarantees for which substitution is applicable
- CRR has never considered a substitution approach for completion guarantee on the part of an exposure secured by unfinished property; the EBA mandate is limited to the specification of what constitutes an equivalent mechanism that gives enough certainty about the completion without any provision for changing the CRR risk-weighting approach.
- Considering that the unexpected losses on the part of the loan secured by the unfinished property is the same as the one of a direct exposure to the completion guarantee provider is ignoring that the borrower must have early defaulted while there was at the same time an event preventing the developer to finish the property so that the lending institution is economically exposed to the completion provider. This would tend to justify a lower applicable RW than the one of the completion provider: the secured RW of 20% is still relevant when there is an equivalent legal mechanism regardless of the RW of the completion guarantee provider.

Q4: In the case where the requirements on the guarantee would be limited to cover the simple case where the construction works are impeded by financial difficulties faced by the real estate developer, which other mechanisms could ensure the appropriate recognition of the construction risk beyond the creditworthiness of the real estate developer in the own fund requirements?

The failure of the real estate developer in its contractual obligation is mainly resulting either from financial difficulties or from fraudulent behavior and equivalent (non-compliant delivery). This latter risk that could jeopardize the achievement of the construction is mitigated as per the below

- Banks are required to perform enhanced Know Your Customer due diligence whereby the activity, reputation, ownership, business history etc. of the real estate developer are to be screened out before it is onboarded as a client
- Buyers have legal recourse whereby the court can recognize the failure of the real estate developer in its contractual obligation and have it finalize the construction or can designate a competent third party to identify and perform the required works.
- In some jurisdictions, sale of property under construction is a regulated activity, as a result construction works are subject to multiple mandatory insurance schemes to secure the building operations: builder's liability insurance ("tous risque chantier"), two years warranty on equipement, mandatory insurance on the building's defects after completion (assurance "dommage-ouvrage")

In addition, as a general remark regarding point d), we would like to highlight again that such completion guarantees are rather performance bonds (since also contingent to the failure of the developer in its duty in regards of the construction completion) whose mechanism is framed by dedicated consumer protection law but not pure financial guarantees. As such they cannot meet exactly the same eligibility criteria than the ones required by CRR for the recognition of guarantees as credit risk mitigant. This would lead to supersede national law requirements in terms of guarantee eligibility. The fact that they are enforced by law in a mandatory manner shall thus be sufficient for their eligibility for the purpose of having enough certainty of the finalization of a real estate property taken as collateral.

When it comes more specifically to point d)iv), we strongly disagree with the proposal of restricting protection providers to entity without any link with the lending institution. From a bank’s perspective, providing a completion guarantee to the real estate developer and financing a mortgage loan are two different risks by nature, which follow specific risk assessments and prudential treatments in the CRR3. Each risk is therefore properly managed by the bank, adequately priced and it is covered by dedicated own funds requirements.

If we take the case of a lending institution that is also the completion guarantee provider, this institution will compute RWA related to the UL generated by the completion guarantee. If this UL materializes, it means the completion guarantee has been called, which generates losses reducing own funds of the institution as a protection provider. Now if these losses are accounted for, it means that the real property is going to be finalized, to the benefit of the institution as a provider of a collateralized loan in case of the borrower’s default. Disallowing to recognize the effect of such a completion guarantee will on the contrary lead to have more UL/RWA generated by the loan provided to the buyer since considered as unsecured. This would generate a double counting of RWA for losses that cannot coexist.

Furthermore, contrary to what the EBA suggests, we believe that combining the roles of guarantor and lender gives banks a comprehensive control of the risk borne by the different phases of the real estate project. Such a pattern notably provides banks the right incentives to achieve the real estate building in case of failure of the real estate developer, to the mutual benefits of the bank and of buyers.

Conclusion on completion guarantee eligibility criteria

Overall we suggest to adapt the conditions a) to d) as per the below:

- Point c) - the minimum level of creditworthiness should not be based on risk weights but instead should be set to a minimum CQS of 2 , or for unrated institutions, qualifying for Grade A under SCRA, without any RW substitution.

- Point d)ii) - this condition should only be applicable when the contractual arrangement of the completion guarantee provides also for reimbursement guarantee, which is not necessarily mandatory.

- Point d)iii)
  - First bullet should be erased (see answer to Q2)
  - On the third bullet, point completion guarantee contract may contain exclusion clause of Force Majeure event; nevertheless, such clause should not be disqualifying since the realization of this type of event is either highly likely to have a very detrimental impact on the value of a finished property too or covered by home insurance, that is usually contracted by the buyer before the full completion.
  - On the fourth bullet point, we need to have confirmation that the preclusion of clause preventing "the protection provider being obliged to finish the construction [..] in a timely manner" is to be read as a clause that would allow the protection provider to finish the property only before a given date that is beyond the usual period requested for construction. Otherwise the timely manner condition would be too stringent given the specificity of the protection.

- Point d)iv) should be erased (see Q4)

Q5: Which specificities of IPRE and non-IPRE exposures could warrant differentiated requirements on the equivalent mechanism?

This substitution method proposal, in addition to its other limitations highlighted in this document, would be only applicable in the context of the application of loan splitting approach, i.e. for non-IPRE exposures or some specific IPRE ones. This approach is not consistent across exposures secured by immovable property and would thereby unduly penalize IPRE loans. We are therefore of the opinion that the proposal is going too far in fully considering the completion guarantee as a credit risk mitigant. This view relies on the fact the guarantee is not here to protect the bank against the default of its client, but allows the bank to consider with enough certainty that the collateral reaches on average its value upon completion. The RW substitution should not be contemplated.

We see no valid reason why IPRE and non-IPRE exposures would follow differentiated requirements regarding completion guarantees: IPRE and non-IPRE qualify the use made by the buyer of the residential unit, and they are not relevant criteria to assess the risk of non-completion of the property.

ANNEX A

FRENCH EQUIVALENT LEGAL MECHANISM

The financial guarantee of completion (ie. "GFA"), also called the extrinsic guarantee, is an insurance that guarantees the purchasers the delivery of their VEFA dwelling (sale in the future state of completion). Defined and regulated by Articles L261-10-1 et seq. of the French building and housing code, the GFA therefore ensures the purchaser of new real estate that its property will be completed, even in the event of financial discrepancies of the developer.

In France, real estate professionals are required to subscribe a GFA in the context of residential immovable property projects. It is optional for commercial projects.

We believe that the GFAs meet the concept of equivalent mechanism referred to in Article 124(3) of CRR3. It is a guarantee:

- imposed by law (cf. building and housing code)
- provided by financial institutions (banks and insurance)
- whose purpose is to ensure that the property can be completed

BELGIAN EQUIVALENT LEGAL MECHANISM

"Guarantee Breyne" applicable in the case of "sale before completion contracts" (Ventes sur plan) constitutes an obligation set out in the Belgian civil law. They are applicable to all real estate developers and ensure that the property under construction will be finished, should the real estate developer fail to complete its obligation to complete the construction of the real estate property.

The default of completion can be declared following a contractual breach by the developer, or even its own bankruptcy, but also following an action by the purchaser activating the completion guarantee until the very day of delivery of the property of the apartment, which he can denounce for non-compliance.

The bank will continue the construction and pay all the craftsmen and companies chosen to complete the work. By replacing the real estate developer, the bank has all the funds from the buyers available for construction. The risk for the bank issuing the completion guarantee is therefore a risk of additional cost of the works undertaken to complete the construction.

LUXEMBOURGISH EQUIVALENT LEGAL MECHANISM

Completion guarantees applicable in the case of "sale before completion contracts" (Ventes en futur état d'achèvement) constitute an obligation set out in the Luxembourgish civil law. They are applicable to all real estate developers and ensure that the property under construction will be finished, should the real estate developer fail to complete its obligation to complete the construction of the real estate property.

The default of completion can be declared following a contractual breach by the developer, or even its own bankruptcy, but also following an action by the purchaser activating the completion guarantee until the very day of delivery of the property of the apartment, which he can denounce for non-compliance.

The bank will continue the construction and pay all the craftsmen and companies chosen to complete the work. By replacing the real estate developer, the bank has all the funds from the buyers available for construction. The risk for the bank issuing the completion guarantee is therefore a risk of additional cost of the works undertaken to complete the construction.

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