POSITION PAPER

ESBG response to the EBA consultation on Draft Guidelines on ADC exposures to residential property

ESBG (European Savings and Retail Banking Group)

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ESBG

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?

The guidelines on ADC exposures to residential property under Article 126a (2) a) of the CRR are meant to specify the conditions for assigned a risk weight of 100% for ADC exposures where a legally binding ″pre-sale″ or ″pre-lease″ contract containing certain credit risk-mitigating factors has been concluded.

Even though the EBA has not received a mandate to further specify what constitutes inter alia a ″pre-sale contract″, the EBA considers such contracts as preliminary to a sale contract where the buyer is allowed to terminate the contract ″instead of proceeding with signing the sale contract″, cf. section 1.1 (explanatory text) of the draft guidelines. Furthermore, the EBA considers that the ″pre-sale″ contracts must ″specify the sale contract and sale price″, and that the cash deposit ″should be substantial enough to serve as an incentive for the purchase to convert the pre-sale ... contract into a sale ... contracts″, cf. section 1.1.

For some ESBG jurisdictions, this distinction is important. For instance, in Norway, contracts to purchase a property – fully developed or under acquisition, development, and construction – are legally binding without a general right of recourse, as any other contracts. Such contracts are final and not converted to other contracts, and allow no possibility to be terminated by the buyer. In addition, the buyer is fiscally responsible to cover any market losses faced by the developer in case of default on the contract. As such contracts may not be terminated by the buyer, we assume that the requirements in the guidelines relating to substantial cash deposit will only be relevant for the Norwegian market in as so far, the relevant contract is structured as "letter of intent" or similar where the developer bears a legal risk for the subsequent conclusion of a binding sales contract. Our understanding is hence that in order to qualify for a 100% risk weight in accordance with article 126a (2) a) only the requirement of "significant portion of total contracts" is relevant. This is also in line with the current practice of Norwegian authorities, where a 100% risk weight is assigned to exposures where the borrower has entered into legally binding sales contracts that cover more than half of the total loan amount. It would be helpful if these clarifications were included in the final guidelines.

Regarding pre-lease contracts where a prospective tenant enters into a preliminary contract or a "letter of intent" and pays a cash deposit subject to forfeiture if the contract is terminated is not market practice in the Norwegian market. If lease contracts are signed with future tenants of a property, these would be regular lease contracts, usually with a period of notice of three months. Our understanding is that these lease contracts, as for the aforementioned sales contracts, are not subject to the requirement of substantial cash deposit – only the requirement of "significant portion of total contracts".

Also, it is worth noting that legally speaking, pre-lease contracts are prohibited in some countries.

ESBG members also suggest that a clarification of the phrasing "legally binding, except mandatory withdrawal rights of the buyer" would be helpful. For example, the Austria law regulating the drawing plan and securisation of disbursements according to the construction progress (*Bauträgervertragsgesetz*) 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.

A similar situation applies for the Swedish market where the Tenant-Owned Housing Act regulates those situations in which the buyer has the right to withdraw from the pre pre-advance agreement and the occupancy agreement. Since these rights cannot be waived by contract this should be clarified in the guideline.

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

ESBG understands that it would be helpful if the EBA could clarify whether the threshold for the ratio "CD/SP" is to be applied on a contract-by-contract basis or on an aggregated level of contracts basis, i.e., the aggregated amount of cash deposits for all up-to-date signed and legally binding pre-sale contracts and the aggregated amount of sales price for all up-to-date signed and legally binding pre-sale contracts. For instance, in Sweden, it is still common that the cash deposit paid is an absolute amount irrespective of the sales prices of the apartment/house.

Further to the comments concerning Sweden in question 3, are there any criteria that need to be fulfilled concerning the timing of the payment of the 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?

In some jurisdictions, such as Austria, there are no penalties at the moment, except the compensation for proven expenses, as indicated in our answer to question 1.

In other jurisdictions, the maximum level of cash deposit is constraint by legal requirements. For example, in France, cash deposits are limited to 5 % of the sale contracts as defined by the consumer protection act for residential market.

In Sweden, furthermore, the market standard is that the cash deposit is paid in several steps (please see comment on question 2). Initially a pre-advance agreement is signed and a fee is paid. The fee can amount to (50,000 – 100,000 SEK) or 2-3 per cent of the sales prices. It will seldom amount to 10 per cent of the sales price. Should the contract be terminated by the buyer the paid cash deposit will be subject to forfeiture unless any of the conditions for termination according to the Tenant-Owned Housing Act are fulfilled. 3-6 months prior to the date of access to the apartment/house an occupancy agreement is signed. The buyer then makes a payment of, at least, 10 per cent of the sales price. The initial cash deposit is deducted.

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.

See answer to question 3.

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?

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

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.

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.

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.

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. Guarantees issued by banks and other institutions that have a certain credit rating (e.g. investment grade) should at least be admitted.

Question 10: Do you agree in using two different options for pre-sale/sale and pre-lease/lease contracts?

In general, ESBG agrees with the suggested options.

ESBG members assume that where no contracts meet the characteristics of a "pre-sale contracts", it is the sum of binding "sales contracts" that represents the decisive factor (numerator). This should be clarified by inserting the wording "and/or" between i. and ii. in section 14(a) of the draft guidelines.

ESBG furthermore believes that it is important to note that the options suggested by the EBA may not be applicable in all jurisdictions. Therefore, some flexibility should be ensured in order to allow for more robust and consistent calculations. For instance, option 1, based on the credit facility, does not comply with the under-writing standards of some jurisdictions, such as Sweden. The credit-facility based ratio mixes different concepts; on one hand the progress of the project (i.e. the business risk of the project) and on the other hand the financing risk of the project. Not only does it not fit the current market practice and underwriting criteria/standards in Sweden, but it might also throw the market out of balance and hence hamper the residential real estate market in this country.

Considering the market specificities as the ones described above, we would kindly request the EBA to also consider option 3 as a way of measuring the "legally binding pre-sale contracts that amount to a significant portion of total contracts", where other measuring options may not be practicable. CRR 3 points out, on this matter, that the number of legally binding pre-sale contracts should amount to a significant portion of total contracts.

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

The pre-sales resp. pre-rent quota of 50% is far above actual market standards and policies as adopted by the respective supervisory authorities. For example, in Austria, a quota of 30% is the market standard. In other markets, larger listed companies/company groups with an investment grade rating might have even a smaller quota than 30%.

ESBG would like to request the EBA to address the following queries:

- Does the phrasing "legally binding" in this section mean that the paid instalments are subject to forfeiture if the contract is terminated (if permitted by law)?

- Does the phrasing "legally binding sale or lease contracts, including where the payment is made by instalments as the construction works progress, amount to a significant portion of total contracts;" suggest that payment of instalments is an alternative to cash deposits? Can a set-up with a pre-advance agreement, which is linked to a fee, and an occupancy agreement, which is signed 3-6 months prior to the access to the apartment/house, and linked to a payment of a cash deposit amounting to, at least, 10 per cent of the sales price, be equivalent to the phrasing "instalments as the construction works progress"?

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?

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?

See answer to question 12.

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?

See answer to question 12.

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?

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?

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.

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.

If the wording "residual claim" refers to that the claim of the obligor is subordinated to the claim of the institution, then it might be helpful if the wording "subordinated" is incorporated into the section 19 of the GL or that it replaces the wording "residual claim".

Question 18: What are your views on the proposed threshold for determining the appropriateness of the amount of obligor-contributed equity? Please provide reasoning, taking into account market practices and underwriting standards if you think that an adjustment of the EBA's proposal is necessary.

The level of obligor-contributed equity is considered too high, compared to market standards in some ESBG member jurisdictions (for example, 20-25% equity ratio in Austria). It should therefore be set lower than 35% (e.g. 25%) for ADC exposures where the obligor intends to rent out the property. It is considered to be less risky to rent out a residential property than to sell a property with profit.

It could also be argued that larger listed companies with an investment grade rating might be subject to a lower threshold based on a diversified source of external financing (issued bonds, bank loans).

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?

The denominator for calculating the appropriate amount of the obligor-contributed equity is the residential property's "value upon completion". The obligor-contributed equity shall be investments such as cash, subsidies and grants, unencumbered readily marketable assets, expenses for development construction and land or improvements. However, at early stages in a development project, the equity at risk is rather derived from the difference between the total estimated costs of the construction of the residential property, and the total loans provided by the banks for the project. Thus, obligor-contributed equity should not be limited to already contributed equity. In some cases, the difference between total costs of the project minus total loans is a more appropriate reference to determine the equity risk of the developer.

In any event, guarantees and other form of collateral should be added to the list of "investments", cf. section 19 of the draft guidelines. It is difficult not to view such guarantees as a sufficient obligor-contributed equity as long as the money paid by the guarantor may be reclaimed to the obligor.

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

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.

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

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.
- An 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). When it comes to public housing it is quite unusual to require a cash deposit as the purpose of the public housing is public benefit where also tenants with a weak position in the housing market must be attracted.

Therefore, waiting lists without penalties should be sufficient, since no binding (pre)contracts exist at the time of granting the loan.

About ESBG (European Savings and Retail Banking Group)

ESBG is an association that represents the locally focused European banking sector, helping savings and retail banks in 17 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 871 banks, which together employ 610,000 people driven to innovate at 41,000 outlets. ESBG members have total assets of €6.38 trillion, provide €3.6 trillion loans to non-banks, and serve 163 million Europeans seeking retail banking services.

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