Finance Finland

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

National specificities should be taken into account in the ADC Guidelines

# EBA ADC consultation 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.

# FFI answer

Finance Finland (FFI) does not agree with the strict equivalence with respect to cash deposit proposed as it is absolutely necessary to take into account national market specificities to which strict equivalence does not fit well. There are national specificities which have been in place for decades and mandatory rules explicitly stipulated in the national legislation, which have successfully made sure that the same goals are achieved than those EBA guidelines try to achieve now. The current national rules are even better suited to the national market practices and legislation than the rules EBA proposes now. In this kind of situation, the EU’s general principles of proportionality apply so that EU should not propose something that achieves the intended goal worse than national legislation already does.

In Finland national legislation creates specific institutional structures – so called RS System – and legal obligations to the parties of the construction project which make sure that RRE construction projects are completed and thus RRE loans are secured against credit losses by the RRE collateral.

RS-System (including RS contracts and RS loans) has been deemed to be solid in practice as credit losses for banks from this kind of projects have been low through the economic cycle. We provide further explanation of the Finnish system below together with legal grounds based on EU law explaining why this ought be taken into account in the guidelines.

The Finnish RS system has been created to ensure that the construction of the residential real estate is completed. In practice, the system also works in accordance with the goal, because residential buildings are rarely left uncompleted in Finland. Although the system is built primarily to protect the consumer, it also indirectly reduces bank's credit risk, as there is a high probability that the RRE buildings will be completed and the loans will be paid. Banks' loan losses have remained low from such exposures.

# FFI Proposal

In order to cover the equivalent manner of ensuring financing described above, we propose the following wording for paragraph 12 of the EBA guidelines:

Financing ensured in an equivalent manner

12.Fo*r the purposes of Article 126a(2), point (a), of the CRR, the financing should be considered as ensured in a manner equivalent to cash deposits subject to forfeiture where* ***either*** *all the following conditions are met:*

 *a. the purchaser or tenant paid instalments, or transferred cash to a segregated*

*account;*

*b. the instalments or segregated cash referred to in point (a) are subject to forfeiture*

*if the pre-sale or pre-lease contract is terminated;*

*c. the amounts of instalments or segregated cash referred to in point (a) are*

*substantial in accordance with the ratios referred to in paragraphs 10 and 11 of*

*these Guidelines, for pre-sale contracts and pre-lease contracts, respectively;*

***or*** *the following condition is met:*

*in the case of a housing company ordering construction work, there is explicit national legislation in place for the ADC phase, containing specific legal obligations for the project with the purpose of ensuring the buyer that construction will be completed. These shall at least include a cash deposit or a guarantee or insurance by the construction company and the buyer’s front payment that together equal at least 10 % of the agreed construction costs or of the total credit facility.*

# Rationale

It is very important that CRR3 and EBA guidelines take into account the national legislative framework and market specificities which are well established and have been in place for several decades with the purpose to minimize the risk of the event that the construction of a residential real estate is not completed. This in turn commits the buyers to the completion of the construction project. This kind of situation is in Finland, where the legal requirements are stipulated in the mandatory national legislation for so-called RS system. Due to its success in practice, it has become a predominant way of organizing the construction of RREs in Finland as it has guaranteed the completion of the RREs.

In the draft Guidelines EBA points out the following concerning the relationship of equivalence to the requirement for a “substantial cash deposit”. In order to preserve the equivalence to the cash deposit from a risk perspective, instalments paid, and cash held in a segregated account, both subject to forfeiture if the contract is terminated, are considered as ensuring the financing in an equivalent manner compared to a cash deposit.

In the Finnish RS System, the obligor receives a specific amount of cash or guarantee from the construction company who owns the shares of the housing company. The construction company or the subsequent buyer of the shares of the housing company lose their rights to cash deposit invested by the construction company should they walk away from the project. When these amounts are separately or together equal to the amount that EBA GL mandates it means that legally and in economic sense these amounts are equivalent to the cash deposit mentioned in the EBA draft guidelines.

When ensuring financing in an equivalent manner in case of housing companies (which are counterparties to credit institutions), the minimum amount of collateral should be defined relative to construction costs. The guideline could also accept the comparison to the amount of credit facility, which would make it possible to take the amount of risk more precisely into account.

# EU Law

As EBA states the interpretation adopted for the term “financing ensured in an equivalent manner” is one of strict equivalence with the cash deposit. FFI sees that this kind of strictness is not warranted. Instead, different economic substance and legal form should be considered if these in reality fulfill the purpose meant in the wording of the act. FFI sees that interpretation of the CRR3 should take into account also other forms of equivalence than pure cash, such as guarantees, as no legal source clearly demand interpretation which could warrant the restrictive interpretation EBA presents. As long as financial resources of the owner of the company are lost if the contract is terminated, the “substance over form” -principle should apply and the form of equivalent finance stipulated in the Finnish national law should be allowed.

It should also be kept in mind that EBA should adhere to the principles of subsidiarity and proportionality which are the General principles of EU law. Principle of proportionality states that any action by the community shall not go beyond what is necessary to achieve the objectives of the legislation. This also deems it necessary for the EBA to accept the equivalent means stipulated in national legislation as there is no proof that the proposed action cannot be sufficiently achieved by Member States' action in the framework of their national constitutional system. In line with the principle of subsidiarity it should be noted that there is a well-functioning framework in place in Finland and the intended objectives cannot therefore be better achieved by action on the part of the Community. Community action should be taken if and in so far as the objectives of the proposed action cannot sufficiently be achieved by the Member States. The objectives can be achieved sufficiently by the Member State as the Finnish RS system has proven its resilience for decades and through the economic cycle. Thus in Finland national legislation achieves the goals meant in the CRR3 Article 126a(2), point (a).

FFI sees that the general principles of EU law must be adhered to. They clearly state that in exercising the powers conferred on it, each institution shall ensure that the principle of subsidiarity is complied with.

# Summarized descriptions of the Finnish RS System and the Finnish housing company

The main elements of the Finnish RS System are defined in the Housing Transactions Act. In the RS System apartments are sold during the construction phase.  The interests of buyers are protected in accordance with Chapter 2 of the Act. The main protective provisions are as follows:

* The trade in the construction phase must be made in writing.
* The seller must place the security documents required by the Act to be stored in a bank or regional administrative office. Security documents form the framework for project implementation. These include security certificates, financial plan, property information, building permit and permit drawings, construction method report and special work reports and contract.
* The seller must provide the securities required by the Act for the benefit of the housing company and the shareholders. Securities include security for construction phase, security after the construction stage and security arrangements against a founding shareholder´s insolvency
* Buyers have the right to choose a construction observer and an auditor as their representatives.

A housing company is a specific type of limited liability company regulated by the Finnish Housing Companies Act. A housing company owns a residential real estate and shares in the housing company entitle their holder to possess certain premises in the building owned by the housing company as stipulated in the articles of association of the housing company. In respect of buildings under construction, it is common practice that the builder (a construction company) establishes a housing company and the residential building to be constructed is owned by the housing company which pays the construction costs to the builder. The builder initially owns the shares in the housing company and then markets and sells them to the apartment buyers. The obligor in a standard Finnish residential construction loan is the housing company and it repays the loan to the bank with funds that it collects from its shareholders (i.e. either the builder or the apartment buyers).

Under the Finnish Act on Credit Institutions, a credit institution may grant a loan to a housing company in the construction phase within the meaning of Chapter 1, Section 5 of the Finnish Housing Transactions Act, with the maximum amount corresponding to 60 per cent of the debt-free price of the housing company shares offered for sale.

FINANCE FINLAND

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