Public Hearing: Consultation on GLs on ADC exposure to residential property

EBA Prudential Regulation and Supervisory Policy

Virtual meeting, 20 June 2024
## Ground rules for this virtual meeting.

<table>
<thead>
<tr>
<th>Mic and video off</th>
<th>Questions/comments?</th>
<th>Slides on EBA website</th>
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</thead>
<tbody>
<tr>
<td>Please keep yourself muted and the video off while listening.</td>
<td>Please use the chat or raise your hand to ask for the floor.</td>
<td>The presentation used today will be made available on the EBA’s website after this hearing.</td>
</tr>
</tbody>
</table>
## Contents

1. EBA Roadmap on CR mandates under CRR3
2. Legal basis and Scope of the GLs
3. Condition 1
4. Condition 2
5. Public housing framework
6. Next steps
01

EBA Roadmap on CR mandates under CRR3
EBA Roadmap – Overview CR

Phase 1
Implement the critical elements of the SA and review targeted elements of the IRB frameworks.
This group mostly covers mandates related to the SA, with the notable exception of a review of the frameworks on the definition of default and on the categorisation of model change.

Phase 2
Specify the treatment of project finance under the SA, start the review of the IRB repair programme products.
The mandates mostly relate to clarification on the IRB approach, while on the SA some specifications are provided on the newly introduced specialised lending exposure class.

Phase 3
Complement the IRB repair programme.
The key product will be the publication of the guidelines on CCF estimation. This phase also contains various reports assessing specific elements of the Basel III framework in the context of its EU implementation.

Phase 4 and later
Finalise the assessment of the framework.
Most of the mandates relate to reports assessing specific elements of the Basel III framework in the context of its EU implementation, with the policy work confirmed to target elements of lower materiality.
## EBA Roadmap – CR Phase 1

<table>
<thead>
<tr>
<th>Area</th>
<th>Product</th>
<th>Reg.</th>
<th>Article</th>
<th>Deliverable</th>
<th>Legal deadline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit risk</td>
<td>Report</td>
<td>CRR</td>
<td>506</td>
<td>Report to the Commission on the eligibility and use of policy insurance as credit risk mitigation techniques</td>
<td>0 months after entry into force</td>
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<tr>
<td>Credit risk</td>
<td>ITS</td>
<td>CRR</td>
<td>20(8)</td>
<td>ITS on joint decision process for internal model applications</td>
<td>12 months after entry into force</td>
</tr>
<tr>
<td>Credit risk</td>
<td>RTS</td>
<td>CRR</td>
<td>111(8)</td>
<td>RTS on criteria that institutions shall use to assign off-balance-sheet items, constraining factors for UCC and notification process</td>
<td>12 months after entry into force</td>
</tr>
<tr>
<td>Credit risk</td>
<td>Guidelines</td>
<td>CRR</td>
<td>123(1)</td>
<td>Guidelines to specify proportionate diversification methods for retail definition</td>
<td>12 months after entry into force</td>
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<tr>
<td>Credit risk</td>
<td>ITS</td>
<td>CRR</td>
<td>124(12)(sub 1)</td>
<td>RTS to specify the term “equivalent legal mechanism” in place to ensure that the property under construction will be finished within a reasonable time frame</td>
<td>12 months after entry into force</td>
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<tr>
<td>Credit risk</td>
<td>Guidelines</td>
<td>CRR</td>
<td>126a(3)</td>
<td>Guidelines specifying the terms substantial cash deposits, appropriate amount of obligor-contributed equity and significant portion of total contracts</td>
<td>12 months after entry into force</td>
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<tr>
<td>Credit risk</td>
<td>Guidelines</td>
<td>CRR</td>
<td>178(7)(sub 1)</td>
<td>Guidelines on the definition of default, in particular for diminished financial obligation</td>
<td>12 months after entry into force</td>
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02

Legal Basis and Scope of the GLs
Legal Basis and Scope

Article 126a

EBA shall by ... [1 year after entry into force] issue guidelines specifying the terms “substantial cash deposits”, “financing ensured in an equivalent manner”, “appropriate amount of obligor-contributed equity”, and “significant portion of total contracts”, taking 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.

Scope of the CP GLs

Definition of ADC (Article 4(1)(79)): exposures to corporates or special purpose entities financing any land acquisition for development and construction purposes, or financing development and construction of any residential or commercial immovable property;

Preferential Risk Weight Treatment: 100% instead of 150% for ADC exposures to residential property

- **Condition 1**: Significant portion of total contracts of which:
  - Pre-sale / pre-lease contracts with substantial cash deposit, or finance ensured in an equivalent manner (FEM).
  - Sale and lease contracts.

- **Condition 2**: Appropriate obligor-contributed equity relative to property value upon completion.
03

Condition 1
Condition 1: Overview

Q1: Pre-sale and Pre-lease characteristics
Q2: Relative Thresholds
Q3: Adequacy of 10% pre-sale contract ratio
Q4: Differentiation thresholds based on empirical data
Q5: Drawbacks of pre-lease contract ratio
Q6: Other alternatives for the ratio
Q7: Like Q4 but for pre-lease ratio
Q8: Ratios equally substantial for pre-sale and pre-lease
Q9: Other forms of FEM

Pre-sale contract

\[
\frac{CD}{SP} \geq 10\%
\]

Or FEM

Subject to forfeiture

Pre-lease contract

\[
\frac{CD}{MR} \geq 300\%
\]

Or FEM

Subject to forfeiture

sale contract

lease contract

\[\geq 50\%\]
Condition 1: How is the significant portion calculated?

**Q10**: Two different options for sale and lease
**Q11**: Drawbacks for the two above ratios
**Q12**: Materiality of mixed-use ADC projects

**Q13**: Pros & Cons of the approaches considered
**Q14**: Agreement with the Approach proposed
**Q15**: Other possible approaches

**Q16**: Other possible approaches for mixed use ADC projects

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**Sale and Pre-sale contract**

\[ \frac{\sum P \text{ (Pre – sale with cash deposit or FEM, sale contracts)}}{\text{Credit Facility including the drawn and undrawn amount}} \geq 50\% \]

\[ *P = \text{sale price} \]

**Lease and Pre-lease contract**

\[ \frac{\sum N \text{ (Pre – lease with cash deposit or FEM, lease contracts)}}{\text{Total Number of units for lease}} \geq 50\% \]

\[ *N = \text{Number of contracts} \]

---

**MIXED USE**

Portion of total contracts significant: both ratios \( \geq 50\% \)
Condition 1: Example 1

Bank B grants Realty Corp an ADC loan of EUR 20 million. The project consists of 70 apartments for sale and 30 for lease.

As of today, Real Estate Corp has achieved the following objectives:

- Pre-sold 6 apartments, of which 5 with substantial cash deposit. The 5 with cash deposits have been sold for a total of 1 million.
- Sold 35 apartments for 10 million.
- Pre-Leased 12 apartments, of which 11 with substantial cash deposit.
- Leased 5 apartments.

Calculation of the significant portion of total contracts

\[
\sum P (\text{Pre – sale with cash deposit or FEM, sale contracts}) = \frac{(1 + 10)}{20} = 55\% \\
\sum N (\text{Pre – lease with cash deposit or FEM, lease contracts}) = \frac{(11 + 5)}{30} = 53\%
\]

Both ratios exceed the 50% threshold: RW = 100%.
Bank B grants Realty Corp an ADC loan of EUR 20 million. The project consists of 70 apartments for sale and 30 for lease.

As of today, Real Estate Corp has achieved the following objectives:

- Pre-sold 6 apartments, of which 2 with substantial cash deposit. The 2 with cash deposits have been sold for a total of 0.5 million.
- Sold 28 apartments for 8.5 million.
- Pre-Leased 12 apartments, of which 11 with substantial cash deposit.
- Leased 5 apartments.

Calculation of the significant portion of total contracts

\[
\sum P \text{ (Pre – sale with cash deposit or FEM, sale contracts)} = \frac{(0.5 + 8.5)}{20} = 45\%
\]

\[
\sum N \text{ (Pre – lease with cash deposit or FEM, lease contracts)} = \frac{(11 + 5)}{30} = 53\%
\]

⇒ One of the ratios does not exceed the 50% threshold: RW = 150%.
04

Condition 2
Condition 2: Forms of equity

5 forms(*) of “eligible” equity, which is only a subordinated residual claim on the property, are defined:

- Cash invested in the project and segregated from other assets;
- Subsidies and grants;
- Unencumbered readily marketable assets directly linked to the project;
- Expenses for development or construction;
- Land or improvements.

(*) complete description in the CP.

\[
\frac{\text{Obligor contributed equity}}{\text{Property Value upon completion}} \geq 35\%
\]

Q17: Practical impediments in the residual claim feature
Q18: Appropriateness of the threshold
Q19: Appropriateness of the approach and other options
Q20: Calibration of the level of thresholds of both condition 1 and 2
05
Public Housing Framework
Q21: Agreement with the adjusted criteria

**General Framework**

- $\frac{CD}{MR} \geq 300\%$
- FEM: paid instalments, segregated cash
- Significant portion of total contracts threshold: 50%

**Public Housing framework**

- $\frac{CD}{MR} \geq 100\%$
- FEM: paid instalments, segregated cash, penalty fees
- Significant portion of total contracts threshold: 75%
- Property is for lease;
- ADC project qualifies for social/public housing
- Optional «special» framework
Next Steps
Next steps

19 August 2024
- Ends of Consultation Period

2024 Q4
- Processing feedback and finalizing the GLs

2024

2025 Q1-Q2
- Internal bodies approval
- Final Publication of the GLs
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