



ABBL response to EBA CP 2024/11 on draft RTS on equivalent mechanism for unfinished property under Article 124(12) of EU Regulation 575/2013

Author: Gilles Pierre

Date: 12 August 2024

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 de-fault 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?

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 has to be declared by the parties, often based on the bankruptcy of the developer, to enable the purchaser to call the completion guarantee.

In this case, 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.

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)?

Our response concerns Luxembourg banks that issue completion guarantees. Under the new Standardized Approach for Credit Risk applicable in the CRR3, their Risk Weights (RW) for long term exposures are the following:

- For banks rated by a External Credit Assessment Institution (ECAI): 20% and 30%, corresponding to the credit quality steps 1 and 2
- For unrated banks: 40%, corresponding to the grade A as per article 121.2 of the new CRR3

Setting to 20% the maximum RW applicable to guarantors is in our view a questionable approach, which is not guided by a fair assessment of guarantors' specific risk.

- Indeed, for rated banks, this approach would retain solely the banks assigned with the credit quality step 1, thus excluding steps 2 and 3 that are part of the investment grade category.

- Furthermore, the EBA approach unduly excludes unrated banks, which bear a minimum RW of 30% or 40% if they are classified under grade A as per article 121.2 of the CRR3.

Therefore, we call the EBA to set to 40% the maximum RW acceptable for guarantors.

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?

Not applicable in Luxembourg. The default of completion of the construction has to be declared by the parties, whatever the cause: financial difficulties of the developer, or any other cause.

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

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. Furthermore, such a differentiation is not specified in the mandate granted to EBA by art. 124.12 CRR3.

Additional comment on the requirement for the completion guarantee provider to be independent from the institution financing the obligor: point d) iv of the alternative approach

We understand from this requirement that a bank financing the mortgage loan granted to the buyer of a housing in a real estate project must be different from that providing the completion guarantee to the real estate developer. We believe that the rationale underpinning the EBA proposal is questionable in terms of risk management for the following reasons.

- 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.
- According to the market practice in Luxembourg, a sufficient level of pre-sales needs to be achieved to finance the construction through the payments to be made by buyers under the VEFA (sale in state of future achievement) regulation. When this level is reached (70% - 80%), banks issue a completion guarantee which is mandatory by law to protect the buyers. On the other hand, the same bank may finance buyers' mortgage loans. 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. It is worth noting that buyers generally prefer having one single bank responsible for both roles.
- Finally, separating the completion guarantee from clients' financing would unduly disrupt the Luxembourg market, where only a few banks are active in the real estate sector, and where it frequently happens that banks complete both tasks.