

IFPIImm - Institut du Financement des Professionnels de l'Immobilier

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BCBS – BASEL COMMITTEE FOR BANKING SUPERVISION SECOND CONSULTATIVE DOCUMENT CONCERNING REVISIONS TO THE STANDARDISED APPROACH FOR CREDIT RISK (D347 DATED 10 DECEMBER 2015)

Position Paper

Version: 10 March 2016

This Position Paper is IFPIImm's direct contribution to the consultation process launched by the BCBS – Basel Committee for Banking Supervision when it published its Second Consultative Document (d347) dated 10 December 2015 concerning revisions to the Standardised Approach for Credit Risk.

Executive Summary

- IFPIImm is France's Commercial Real Estate Finance Institute, grouping together the principal lenders, borrowers and advisors of the CRE sector, in order to provide a balanced view of the major issues facing the sector, and to help in particular international and national regulatory authorities better to understand the specific and heterogeneous nature of our activity.
- The recommendations formulated by IFPIImm in this Position Paper are based not only on the position of our principal bank members, but also on the positions of the French Federation of Property Developers and the French Construction Federation.
- Our recommendations focus on the BCBS proposals to increase the risk-weighting of development finance, and propose that a lower weighting be applied to loans financing land acquisition, development and construction when subject to the long-standing French legal dispositions governing forward sales of property under development. These ensure that the transfer of title to property under development is immediate, certain, firm and definitive.
- We respectfully request that the BCBS give favourable consideration to our recommendations, and we would be happy to meet with the BCBS and its members to discuss the reasons and the evidence underlying our position.

IFPIImm Position

1. IFPIImm

- IFPIImm – Institut du Financement des Professionnels de l'Immobilier (Commercial Real Estate Finance Institute) groups together the principal actors of the CRE sector in France:
 - lenders: BNP Paribas, Crédit Agricole, Société Générale, Natixis, Banque Européenne du Crédit Mutuel, HSBC France, Crédit Foncier, HeLaBa (Hessische Landesbank) France, SCOR Investment Partners ;
 - borrowers: Unibail-Rodamco, Klépierre, Foncière des Régions, Altarea Cogedim, Bouygues Immobilier, Nexity, Vinci Immobilier, Kaufman & Broad, Pitch Promotion ;
 - advisors: De Pardieu Brocas Maffei, Wargny Katz, Gide Loyrette Nouel, Cheuvreux, Lacourte Raquin Tatar, Allez, CBRE Valuation, BNP Paribas Real Estate Valuation France, Cushman & Wakefield Valuation, Mazars.

- Through the contributions of its members, IFPImm aims to develop a better understanding, nationally and internationally, of the major issues impacting the CRE finance sector. In particular, IFPImm seeks to provide to regulatory authorities, the real estate industry and more generally national economic leaders a balanced view of these issues, since it is neither a professional association nor a lobby for particular interests.

2. Context

- The principal French banks, members of IFPImm, began the process of coordinating their positions at publication of the BCBS Consultative Document. Their specific response¹ on the CRE finance proposals of the Consultative Document will be provided to the BCBS as an integral part of the FBF – Fédération Bancaire Française (French Banking Federation) submission, which covers all of the issues raised by the Consultative Document.
- The FPI – Fédération des Promoteurs Immobiliers (French Property Developers Federation, including members of IFPImm) and the FFB – Fédération Française du Bâtiment (French Building Federation) have also prepared position papers² which will be provided directly to the BCBS.
- In its over-arching role as consensus builder for the CRE finance sector, IFPImm has prepared this Position Paper as its own direct contribution to the BCBS consultation process. Our paper is based on the positions of our members (who are also major actors in their representative professional associations), and constitutes therefore a synthesis of their views.

3. Choice of Issue

- The analysis of the principal banks during their preparation of their common position identified the issue of the increased risk-weighting of development finance as their major concern amongst the different proposals of the Consultative Document relating to CRE finance.
- IFPImm agrees that the significant increase in development finance risk-weighting proposed by the BCBS could have a major impact on the French CRE sector (which by definition includes the construction by developers of housing for sale to households and investors).
- We therefore focus this Position Paper on the issue of development finance, while remaining also deeply concerned by the potential disruption caused to the French RRE – residential real estate sector, and by ricochet to our CRE sector, by the BCBS proposals concerning household residential acquisition lending (emphasising the LTV rather than the LTI approach).

4. Development Finance

a) Proposed Risk-Weighting

- The second consultative document (d347 dated 10 December 2015, hereinafter “**Consultative Document**”) of the BCBS – Basel Committee for Banking Supervision proposes the following text concerning development finance risk-weighting:

9.3 Land acquisition, development and construction exposures

61. Land acquisition, development and construction (ADC) lending will be risk-weighted at 150%. ADC includes loans to companies or SPVs financing any of the land acquisition, development and construction of any residential or commercial properties where the source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain. ADC exposures will also include loans to

¹ Attached as Annex 1: CRE Extract FBF Response BCBS 2nd Consultation STD Approach 10March16.

² Attached as Annex 2: FPI EN Position Paper BCBS; and Annex 3: FFB 042 Basel Committee Submission 10March16.

companies or individuals to finance the acquisition of finished property where the repayment of the loan depends on the future uncertain sale of the property.

- IFPImm observes that development finance (ADC loans) in France has proved to be more secure than in most other national jurisdictions, due to the legal dispositions introduced nearly fifty years ago which govern forward sales of property under development, whose purpose is to ensure that the transfer of title to property under development is immediate, certain, firm and definitive.
- We outline these legal dispositions in b) below, and further detail is provided in Annex 4: DPBM VEFA Sale Property Under Development Protected Sector 11March16 (note by DPBM – De Pardieu Brocas Maffei, a major French law firm).

b) VEFA

- Since 1967 French law provides a specific mechanism for forward sale-purchase agreements in the case of real estate development: “*VEFA – Vente en État Futur d’Achèvement*” (literal translation: sale in future state of completion, hereinafter “**VEFA**”).
- When the notarised VEFA deed is signed between the developer and the purchaser of the property concerned, the title of the property (including both land and existing and future construction) is immediately transferred by the developer to the purchaser. This immediate transfer of the legal ownership from the developer to the purchaser is firm and definitive.
- The purchaser has thus acquired *ipso facto* immediate title (at the instant of their execution) to all the remaining construction elements which are then progressively completed by the developer.
- The transfer (sale) of the property being developed is thus immediate and certain, and therefore not dependent on a “future uncertain sale”.
- The VEFA mechanism thus constitutes an immediate and certain sale of the property developed by the developer. The source of repayment of the loan to companies or SPVs financing the land acquisition, development and construction of residential or commercial properties is thus immediate and certain.
- The VEFA mechanism is highly regulated when applied to forward sales of housing development (“protected sector”, covering all residential property irrespective of number or size of units), whether to households, private individual investors, or to major institutions. French banks have experienced low default rates when lending to developers selling housing forward using the VEFA dispositions.
- Commercial real estate (by definition excluding all residential property) can also be forward sold under the VEFA mechanism, but without being obliged to respect the specific regulations applying to the protected sector

5. Recommendations

- **IFPImm therefore recommends that loans to companies or SPVs financing the land acquisition, development and construction of properties for sale to households or investors under the VEFA mechanism should benefit from a risk-weighting at 100%, and not at 150% as proposed by the BCBS in paragraph 61 (Article 9.3 of Annex 1 of the Consultative Document) cited above.**
- Our specific recommendations are therefore:
 - lending to finance land acquisition, development and construction (ADC) relating to **residential property** should be risk-weighted at 100% (and not at 150%) as soon as notarised VEFAs have been signed concerning housing units whose aggregate sales price is 30% or more of the expected total sales revenues of the residential development programme financed by the lending concerned;

- lending to finance land acquisition, development and construction (ADC) relating to **commercial property** (excluding residential property) should be risk-weighted at 100% (and not at 150%) as soon as notarised VEFAs have been signed whose aggregate sales price has reached 100% of the expected total sales revenues of the commercial real estate development programme financed by the lending concerned;
- lending to finance land acquisition, development and construction (ADC) relating to **commercial property** (excluding residential property) should be risk-weighted at 100% (and not at 150%) as soon as the asset concerned has been pre-leased (leases signed concerning a defined property under construction for occupation on a defined date on the basis of an agreed base rent) for an aggregate base rent representing 70% of the expected total lease revenues deriving from the asset at completion (thus giving a high probability for the asset to be sold at completion, permitting full loan repayment).
- Concerning **completed commercial property** (excluding residential property), we further recommend that consideration should be given to risk-weighting at 100% all lending to finance land acquisition, development and construction (ADC) on the following basis: 1. the LTV at completion is less or equal to 80% AND 2. either notarised VEFAs or pre-leases (leases signed concerning a defined property under construction for occupation on a defined date on the basis of an agreed base rent) represent a substantial proportion of the total expected sales or lease revenues respectively of the asset concerned.

6. Conclusion

- IFPImm, as the Commercial Real Estate Finance Institute of France, respectfully requests that the BCBS considers favourably our recommendations concerning the risk-weighting of development finance.
- If so requested, we would be delighted to meet with the Basel Committee, with its Secretariat, or with any of the various entities constituting its various working groups and task forces, in order to explain in more detail our recommendations and the reasons and evidence underlying them.
- The sector of commercial real estate and its finance is both one of the largest activities of most national economies, and a field with immense heterogeneities and national specificities rendering it difficult to comprehend without deep knowledge of the national market concerned³.
- **Strict “one-size-fits-all” regulation, while certainly benefitting more volatile markets, risks severely damaging less volatile markets where national legal systems and long-standing market practices already provide sufficient security to lenders and borrowers, and proven protection against financial instability. This damage to the real estate markets will impact national economies, and in particular employment.**

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³ Cf. the ESRB – European Systemic Risk Board report dated 28 December 2015 (Report on Commercial Real Estate and Financial Stability in the EU).

4.4 Land acquisition, development and construction

The ADC loan risk weight treatment (150%) proposed by the BCBS¹ is determined by the fact that the *“source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain”*.

After demonstrating that in France the future sale of property or future cash-flows to allow repayment of the loan are NOT substantially uncertain, we propose that the Committee should give a 100 % risk weight to those development loans which are eligible according to the criteria set out below.

Our proposal is based on minimum thresholds (signed sales or pre-leases) to be reached, the level of such thresholds depending on the asset type (residential or commercial).

Residential development finance

The French residential development financing scheme, which is a common market practice shared by all banks active in France, relies on two key protective elements (both legal and financial):

- The immediate transfer of the legal ownership from the developer to the purchaser(s) through signed notarial acts, even though the building is not completed, and the presence of a bank completion guarantee. Such practice protects all parties (developers, bankers and final buyers). This immediate transfer of legal ownership is executed under the legal mechanism of VEFA (*Vente en Etat Futur d’Achèvement*, defined since 1967 by French law). All sales in France of residential property under development are by law secured by the VEFA mechanism and by its associated financial completion guarantee (GFA – *Garantie Financière d’Achèvement*).²
- The presence of signed notarised VEFA sales as condition precedent. Such signed notarised VEFA sales are one of the key elements to secure the transaction (together with the equity and the developer’s margin), to validate the “adequacy” of the asset within its market and to demonstrate the likelihood of the future sales coming from the residual stock and their future related cash flows.

These legal and financial protections have demonstrated their efficiency during the past years, with very low historical default rates observed in such activity.

- ***As long as signed notarised VEFA sales represent a minimum of 30% of the expected total sale revenues of the residential development programme, we propose that a 100% risk weight is applied to the loans financing this programme.***

Non-residential development finance

Banks are also major partners for the development finance of commercial projects (offices, retail, logistics and hotels).

This lending is often secured by signed notarised sales to investors under the VEFA mechanism, which is a key element to secure the future cash-flows, while relying on a more volatile asset risk profile than residential development finance.

Commercial development lending can also be secured by pre-leases (BEFA – *Baux en état futur d’achèvement*) which secure as well the future cash-flows deriving from the asset(s) at completion.

¹ BCBS Second Consultative Document (d347) dated 10 December 2015: paragraph 1.5.3 (page 14), and Annex 1, section 9.3, paragraph 61 (page 37).

² We understand that similar legal schemes exist for instance in Luxembourg.

⇒ **Proposal to BCBS:**

To be consistent with the risk-sensitive approach for ADC loans (which depends both on the asset type – residential or not residential - and on the level of legal “strength” of the condition precedent – signed notarized sales or pre-leases), we propose the following:

- If the asset is sold (through VEFA) for an amount representing 100% of the expected total sale revenues from the asset being developed, we propose that a 100 % risk weight is applied to the loan financing this development;
- If the asset is pre-leased (leases signed concerning a defined property under construction for occupation on a defined date on the basis of an agreed base rent) for an amount representing 70% of the expected total lease revenues deriving from the asset at completion (thus giving a high probability for the asset to be sold at completion), we also propose that a 100 % risk weight is applied to the loan;
- Finally, if the LTV at completion is less or equal to 80% (which is consistent with the approach summarized in table 12 page 37 of the Consultative Document) AND either signed notarized sales or pre-leases represent a substantial proportion of the total expected sales or lease revenues respectively of the completed asset, we also propose that a 100 % risk weight is applied to the loan.

In France, as in most economies, real estate is a key economic sector with broad impact throughout the economy, in particular on employment and competitiveness. A regular and significant flow of modern buildings, both residential and commercial, helps both the household and the corporate sectors to adapt to rapidly changing economic and demographic circumstances. Development finance is thus vital to maintain this major contribution to the health of the French economy.

For this reason, penalizing loans fulfilling the above described conditions (legal and financial protection), by increasing the cost of development finance, could jeopardize the financial equilibrium of an entire strategic economic sector. This in turn could lead to both a credit crunch and a significant rise of real estate prices and rents, making property increasingly unaffordable for both borrowers and tenants. The French economy will suffer as a result.

We propose therefore the following formulation for § 61:

“61. Land acquisition, development and construction (ADC) lending will be risk-weighted at 150%. ADC includes loans to companies or SPVs financing any of the land acquisition, development and construction of any residential or commercial properties where the source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain. ADC exposures will also include loans to companies or individuals to finance the acquisition of finished property where the repayment of the loan depends on the future uncertain sale of the property.

The repayment of the loan is deemed to be sufficiently secured by both the immediate certain sale of a significant proportion of the property to be developed or by the signature of pre-leases as condition precedent in the following cases:

<i>Residential / Signed notarised sales</i>	<i>Non-Residential / Signed Notarised Sales</i>	<i>Non-Residential / Pre-leases</i>	<i>Non-Residential / Other cases</i>
<i>30% of the expected total sales revenues</i>	<i>100% of the expected total sales revenues</i>	<i>70% of the expected total lease revenues</i>	<i>LTV <= 80% and a substantial amount of notarised sales or pre-leases have been signed</i>

In such cases, the loan will be subject to a risk weight of 100%.”

FPI – FÉDÉRATION DES PROMOTEURS IMMOBILIERS

POSITION PAPER

FINANCE OF REAL ESTATE DEVELOPERS AND OF HOUSEHOLD HOUSING ACQUISITION

11 March 2016

BCBS – BASEL COMMITTEE FOR BANKING SUPERVISION SECOND CONSULTATIVE DOCUMENT CONCERNING REVISIONS TO THE STANDARDISED APPROACH FOR CREDIT RISK (D347 DATED 10 DECEMBER 2015)

CONSEQUENCES FOR THE FRENCH REAL ESTATE MARKET

The **FPI** – Fédération des Promoteurs Immobiliers is the professional association for property developers in France. Its 500 members are grouped in 18 regional chambers, both in metropolitan France and in France's overseas territories and dominiums. The sector's total sales turnover is around €30b annually, and it employs directly over 25,000 persons. It generates activity for a further 400,000 enterprises, employing over 1.5 million persons. The FPI is the principal body representing the property development industry in its relations with France's public authorities, and its statistics and research are invaluable resources for the property industry and more widely for observers of the French economy.

The FPI considers that the proposals of the BCBS concerning the prudential rules applicable to banks, contained in its Second Consultative Document ("**Consultative Document**") concerning Revisions to the Standardised Approach for Credit Risk (D347 dated 10 December 2015), could have negative consequences for the French real estate market.

In its Consultative Document, the BCBS proposes revisions to the risk-weighting of credits which, if they are not modified, will increase very substantially the capital requirements of banks.

In particular, the BCBS recommends the reinforcing of the capital requirements for exposure to:

- specifically, lending for land acquisition, development and construction ("**ADC**"); and
- more broadly, for lending relating to residential real estate ("**RRE**") and commercial real estate ("**CRE**")

These proposals aim at improving banks' sensitivity to the risk of these exposures. But they will have significant negative consequences for the new housing market in France, and in particular on new housing construction.

The finance of housing developers, and of households acquiring housing, will be impacted by the higher cost of borrowing, and by the tightening of credit provision.

The BCBS proposals therefore appear to us to be excessive, and above all completely out of step with the reality of real estate development operations in France, where for fifty years strict legal dispositions govern new housing development and sale transactions.

I. LENDING FOR LAND ACQUISITION, DEVELOPMENT AND CONSTRUCTION

BCBS PROPOSITION:

1.5.3 Land acquisition, development and construction (ADC) exposures¹

ADC exposures would be risk-weighted at 150%, consistent with the 2014 consultative document. This category would include loans to companies or SPVs financing any of the land acquisition, development and construction of any residential or commercial properties where the source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain. ADC exposures would also include loans to companies or individuals to finance the acquisition of finished properties where the repayment of the loan depends on the future uncertain sale of the property.

CONSEQUENCES OF THIS PROPOSAL

Raising the risk-weighting of ADC lending from 100% to 150% would increase the cost of credit. Real estate finance professionals estimate that this cost increase would reduce average total development margin by 50 basis points, leading to a reduction in profitability or to an increase in new housing prices.

The FPI fears in particular that this credit cost increase will have a major impact on smaller development companies, active in the French regions and smaller towns.

Lending to developers in France is governed by strict legal dispositions and prudential practices

Strict Legal Dispositions

France created in 1967 the specific legal mechanism of *Vente en l'État Futur d'Achèvement* ("VEFA"). By this notarised deed, the title of the property (including both land and existing and future construction) is immediately transferred by the developer to the purchaser. The purchaser has thus acquired *ipso facto* immediate title (at the instant of their execution) to all the remaining construction elements which are then progressively completed by the developer. The transfer (sale) of the property being developed is thus **immediate and certain**, and therefore not dependent on a "future uncertain sale" (cf. attached note by a major French law firm).

Strict Prudential Practices

Banks only lend to developers, and only provide their completion guarantees, if reservation contracts have been signed for 50% of the total sales revenue of the development programme concerned. This prudential threshold has been reinforced from the previous market practice of 30%. Loans to developers are therefore only granted when a significant proportion of units has been pre-sold, thus confirming future sales revenues.

Funding by Purchasers

Under the VEFA system, the developer can repay his bank loans from the progressive payments he receives from the purchasers of his housing units. The VEFA mechanism sets limits on the maximum total payment amount: 5% at signature of the notarised VEFA deed, 35% at completion of the foundations, 70% at the completion of the roof, 95% at works completion, the remaining 5% being payable at delivery. During the entire construction process, the purchaser already has full title to his property, from the date of signature of his notarised VEFA deed.

¹ Page 14 of the Consultative Document.

II. RESIDENTIAL REAL ESTATE – LENDING TO HOME-BUYERS AND TO PRIVATE INVESTORS FOR HOUSING ACQUISITION

The FPI is concerned that the BCBS proposals concerning the risk-weighting of residential real estate exposures (see below) will also have negative consequences for the household and private investor housing acquisition markets.

We understand that for **home-buyers** today's situation² is as follows:

- lending to households for housing acquisition is risk-weighted at 35% for the portion of the loan up to an LTV of 80%;
- the portion of the loan exceeding 80% LTV is risk-weighted at 75%.

The Consultative Document proposes the following risk-weighting³:

(Repayment is not materially dependent on cash flows generated by property)

Table 9

	LTV ≤ 40%	40% < LTV ≤ 60%	60% < LTV ≤ 80%	80% < LTV ≤ 90%	90% < LTV ≤ 100%	LTV > 100%
Risk weight	25%	30%	35%	45%	55%	RW _{counterparty} ⁴⁸

Furthermore, we understand that these risk-weightings are not “tranching”, i.e. that – contrary to today's situation – the risk-weighting at each LTV threshold will be applied to the entire loan.

This will obviously penalise in particular first-time home-buyers, and lower income households, whose down-payments are constrained by their weaker economic circumstances.

For **private housing investors** (several million in France), who today benefit from the same risk-weighting as home-buyers, the Consultative Document proposals⁴ are even more negative:

(Repayment is materially dependent on cash flows generated by property)

Table 10

	LTV ≤ 60%	60% < LTV ≤ 80%	LTV > 80%
Risk weight	70%	90%	120%

This significant increase in risk-weighting will have a major negative impact on lending to private housing investors, who own 97% of the private (non-social) housing rental market, and thus constitute a vital component of the health of the French economy⁵.

² Articles 123 and 125 of the European Union CRR – Capital Requirements Regulation dated 26 June 2013, which implements the Basel III standards in the EU.

³ Table 9, paragraph 54, section 9.1, Annex 1 of the Consultative Document (page 36).

⁴ Table 10, reference as above.

⁵ On 1 July 2014 private investors (non-corporate) owned 6.4 million rental housing units in France, and corporate investors 0.2 million units. Social housing (5.2 million units) comprises 43.7% of the total rental stock of 11.9 million units. Home-owners occupy 16.2 million units. Source: INSEE (Metropolitan France, i.e. excluding its overseas departments and territories).

CONSEQUENCES OF THESE PROPOSALS

The BCBS proposals on the risk-weighting of residential real estate exposures will significantly increase the capital requirements of the French banking sector for lending to home-buyers and private housing investors.

French banks will therefore either raise interest margins (to compensate for the additional capital required) or reduce their residential real estate exposures in order to concentrate their lending on other sectors which “consume” less capital.

Both this increase in credit cost and this reduced lending to home-buyers and to private housing investors will severely impact France’s housing market, where there is already (as in many other countries) inadequate supply as household sizes diminish and population rises.

Furthermore, such a severe impact on the French housing market is not justified by its housing credit default history. The level of NPLs – Non-Performing Loans on residential real estate exposures in France has always been extremely low, including during recent economic crises⁶.

This is due to French housing market practice, where lending is based more on the home-buyers’ and the private housing investors’ capacity to service the loan (“income lending”) than on the value of the housing asset concerned (“asset lending”).

The transposition to French residential real estate lending of regulation based on other residential real estate practices (where asset lending predominates) will cause major disruption to the long-established and well-secured housing market in France, which will inevitably have negative consequences for the entire French economy.

⁶ Cf. the most recent report of the ACPR – Autorité de contrôle prudentiel et de résolution (Housing Finance in 2014), which states that the gross NPL rate in 2014 on housing loans in France to private individuals – home-buyers and rental investors – was 1.74%.

BCBS – BASEL COMMITTEE FOR BANKING SUPERVISION
Position paper on second consultative document concerning
revisions to the standardised approach for credit risk (d347 dated
10 December 2015)

The FFB – Fédération Française du Bâtiment (French Building Federation) represents 50,000 member companies, of which 35,000 are in the crafts trade (artisans). The FFB groups together building construction companies of all sizes in order efficiently to promote the collective interest of the Building profession. FFB members are responsible for two-thirds of the annual output of the building sector in France (€ 124 billion), and two-thirds of its total employment (1.1 million).

The BCBS has requested submissions from relevant professional bodies concerning its proposal to revise the standardised approach for credit risk concerning real estate development finance (increasing risk-weighting from 100% to 150% in terms of capital requirements).

The FFB, on behalf of all our membership and in particular on behalf of our combined housing development and construction members, considers that this proposal is both dangerous for our activity and not adapted to our specific national practice.

The BCBS proposal is inappropriate in the French context for the following reasons:

- a) such a severe increase in risk-weighting would have the following impact:
 - it would increase credit cost, since bank capital is expensive;
 - it would risk inducing a credit crunch, if banks' lending capacity due to insufficient capital was too limited compared to credit demand.
- b) such an over-prudent approach to risk-weighting does not take into account the very secure legal mechanism of the French forward sale of property development (VEFA)¹:
 - Since 1967 French law provides a specific mechanism for forward sale-purchase agreements in the case of real estate development: "VEFA – Vente en État Futur d'Achèvement" (literal translation: sale in future state of completion, hereinafter "VEFA").
 - When the notarised VEFA deed is signed between the developer and the purchaser of the property concerned, the title of the property (including both land and existing and future construction) is immediately transferred by the developer to the purchaser. This

¹ Article 1601-3 of the French Civil Code (same text in article L.261-3 of the French Construction and Housing Code): "The sale in a future state of completion is the contract by which a seller immediately transfers to the purchaser its rights over the plot of land as well as the ownership of the existing construction. The structures to be erected then become the property of the purchaser as and when the works progress; the purchaser shall pay the price according to the state of progress of the works. The seller retains the powers of the owner until acceptance of the works".

immediate transfer of the legal ownership from the developer to the purchaser is firm and definitive.

- The purchaser has thus acquired ipso facto immediate title (at the instant of their execution) to all the remaining construction elements which are then progressively completed by the developer.
- The transfer (sale) of the property being developed is thus immediate and certain, and therefore not dependent on a “future uncertain sale”.
- The VEFA mechanism thus constitutes an immediate and certain sale of the property developed by the developer. The source of repayment of the loan to companies or SPVs financing the land acquisition, development and construction of residential or commercial properties is thus immediate and certain.
- The VEFA mechanism is highly regulated when applied to forward sales of housing development (“protected sector”, covering all residential property irrespective of number or size of units), whether to households, private individual investors, or to major institutions. French banks have experienced low default rates when lending to developers selling housing forward using the VEFA dispositions.
- Commercial real estate (by definition excluding all residential property) can also be forward sold under the VEFA mechanism, but without the specific regulations applying to the protected sector.

**THE SALE IN A FUTURE STATE OF COMPLETION (VENTE EN L'ETAT FUTUR D'ACHEVEMENT)
OF ASSETS WITHIN THE "PROTECTED" SECTOR**

The regime of the sale in a future state of completion (*vente en l'état futur d'achèvement*) ("**VEFA**") of assets within the protected sector is a French specificity governed by both the French Civil Code and the French Construction and Housing Code.

The VEFA is notably defined in article 1601-3 of the French Civil Code, which has remained unchanged since its introduction in the French Civil Code pursuant to Article 1 of the Law n°67-3 dated 3 January 1967¹. It has been a well-established system for almost fifty years, and it has further been confirmed by case-law.

1. OVERVIEW OF THE CONCEPT OF SALE IN A FUTURE STATE OF COMPLETION OF ASSETS WITHIN THE PROTECTED SECTOR

1.1 Concept of sale in a future state of completion and specific nature

In the context of a VEFA, the seller undertakes to build the property asset(s) concerned in favor of the purchaser within a time period agreed upon between the parties pursuant to the terms of the notarised deed of sale.

The specific feature of the VEFA is that the seller immediately transfers to the purchaser, as from the execution of the VEFA deed, its rights over the plot of land and, as the case may be, the ownership of the existing buildings, i.e. already carried out at the execution date of the VEFA deed.

The structures to be erected then become the property of the purchaser as and when the works progress.

The purchaser is consequently, as from the execution of the VEFA deed, owner of the plot of land and of any construction carried out until the execution of the VEFA deed, and it subsequently becomes owner of any additional construction. This transfer of property is firm and definitive.

As a result, the full and entire ownership of the property assets concerned is automatically transferred to the purchaser as and when they are erected, immediately upon completion of each element of the property asset. This immediate transfer of ownership of the property asset elements as soon as they are completed does not require any additional legal process such as, for example, the publication at the title publication service

Besides, the circumstance that the purchaser has not paid, before or after the relevant completion date, to the seller the price of any construction component of the property assets completed by the seller subsequent to the execution of the VEFA deed does not, in any manner, reduce the purchaser's full and entire ownership of these construction components.

The seller is consequently creditor of the purchaser, without being able to challenge the purchaser's full and entire ownership of the construction components carried out by the seller and not yet paid by the purchaser.

In return, the sale price is paid by the purchaser in several installments and according to the state of progress of the works.

¹ Article 1601-3 of the French civil Code (same text in article L.261-3 of the French Construction and Housing Code): "*The sale in a future state of completion is the contract by which a seller immediately transfers to the purchaser its rights over the plot of land as well as the ownership of the existing construction. The structures to be erected then become the property of the purchaser as and when the works progress; the purchaser shall pay the price according to the state of progress of the works. The seller retains the powers of the owner until acceptance of the works*".

Until acceptance (*réception*) of the works by the seller and the works contractors, the seller retains the powers of the owner (*maître de l'ouvrage*). The latter is consequently the sole person entitled to select the builders, to establish the works contracts, to proceed with the acceptance thereof, to issue possible defects inspection reports (snagging), and to ensure their lifting without the purchaser having the right to interfere in any manner in these operations.

As the VEFA is a sale contract, it further entails, as from its execution, a firm, final and irrevocable undertaking:

- by the seller: to complete and deliver the property assets sold within the deadline determined by the parties;
- by the purchaser: to pay the agreed price installments as and when the assets covered by the VEFA are constructed and to take delivery thereof within the deadlines and under the conditions determined in the deed of sale.

1.2 Overview and rationale behind the concept of “protected” sector

Under a VEFA, the purchaser incurs the risk that the seller may not, for any reason whatsoever, build the relevant asset(s) in accordance with the contractual provisions contained within the VEFA deed.

This risk is higher when the purchaser pays funds (as security deposit or advance payment) before completion of the assets it has purchased.

In this context, the legislator has organized a legal regime specifically protecting the purchasers of housing units.

This specific regime imperatively applies to the extent that:

- the property assets sold are to be used for housing purposes or for mixed professional and housing use regardless of the capacity of the purchaser (individual or legal entity, professional or consumer);
- pursuant to the deed of sale, the purchaser is compelled to proceed with payments or deposits of funds prior to the completion of the property assets concerned.

These sales fall within the scope of the so-called “protected” sector (the “**Protected Sector**”).

Outside the scope of this sector (within the so-called “free” sector), no specific mandatory rule applies other than the ordinary rules of law governing the sale of building to be constructed.

It should however be noted that even if the VEFA falls within the scope of the Protected Sector, it does not in any way affect the irrevocable, firm and final nature of the undertaking of the purchaser upon execution of the deed of sale to pay the acquisition price of the relevant assets and to take delivery thereof upon completion.

2. A LEGAL REGIME INTENDED TO GUARANTEE THE COMPLETION OF THE PROPERTY ASSETS IN ACCORDANCE WITH THE CONTRACTUAL PROVISIONS AND TO GOVERN THE PAYMENT OF FUNDS BY THE PURCHASER

2.1 At the pre-contract stage: the preliminary agreement and supervision of the security deposit

Within the Protected Sector, the sole type of pre-contract that may be executed - the relevant contract being otherwise null and liable to criminal sanctions - is the preliminary agreement (*contrat de réservation*) whereby the seller undertakes, in consideration for a security deposit, to reserve a property asset for a reserving-purchaser ("*réservataire*") (the "**Preliminary Agreement**").

• **Content of the Preliminary Agreement:** The Preliminary Agreement must include the main information relating to the composition of the assets (number of rooms, surface areas, etc.), the quality of the construction and the performance deadlines of the works.

• **Amount of the security deposit:** The amount of the security deposit to be paid by the reserving-purchaser (*réservataire*) upon execution of the Preliminary Agreement cannot exceed 5% of the sale price if the execution of the deed of sale is scheduled within the year of execution of the Preliminary Agreement; 2% if the execution occurs within two years. No security deposit may be required if this deadline exceeds two years.

• **Advantage for the reserving-seller (*réservant*):** The execution of Preliminary Agreements enables the reserving-seller (*réservant*) to "measure" the reception given to the real estate program it intends to carry out. At this stage the seller is not in any way bound by an obligation to build and sell the real estate program, and can therefore decide to cancel without penalty its project if insufficient Preliminary Agreements (reservations) have been signed.

• **Protection of the reserving-purchaser (*réservataire*):** The funds paid as security deposit must remain unassignable, non-seizable and unavailable until the "end" of the Preliminary Agreement and no remuneration whatsoever may be provided in favor of the reserving-seller.

These three features *inter alia* entail:

- an absolute prohibition for the reserving-developer (*promoteur-réservant*) freely to dispose of the sums delivered as security deposit either in its favor (even to finance the construction) or in favor of third parties until termination of the Preliminary Agreement² either through the execution of the deed of sale, or through cancellation of the seller's project ;
- that the reserving-purchaser (*réservataire*) remains the owner of the sums delivered as security deposit and is the sole entitled to dispose of these sums.

2.2 At the stage of the sale itself: the deed of sale and supervision of the price

The VEFA sale contracts within the Protected Sector must be entered into as notarial deeds. These deeds must contain the technical features of the assets, the completion and delivery dates of the property assets and state the financial conditions of the sale.

Once the deed of sale has been executed, the payments shall not exceed in the aggregate:

- 35% of the price upon completion of the foundations,

² The security deposit is then either deducted from the price should the sale be concluded or, in the contrary case, it is refunded either to the reserving-purchaser (*réservataire*) (if the non-execution of the deed of sale is attributable to the reserving-seller (*réservant*)) or it is retained by the reserving-seller (*réservant*) (if the non-execution of the deed of sale is attributable to the reserving-purchaser (*réservataire*)).

- 70% of the price upon completion of the roof (*mise hors d'eau*), and
- 95% of the price upon completion of the property assets.
- 5% of the price upon delivery of the property assets to the purchaser (except if conformity of the property assets with the contractual provisions is contested).

The payment of the sale price by installments as and when the assets are constructed is intended to protect the purchaser from any possible failure on the part of the seller-builder.

This payment method of the sale price does not however reduce the firm and final commitment taken out by the purchaser upon execution of the deed of sale to pay the entire price of the property assets covered by the VEFA.

2.3 Completion guarantee of the construction or repayment guarantee of the payments made by the purchasers

Considering the financial risk incurred by the purchaser due to the payments made prior to the completion of the property assets concerned, the legislator has imposed the delivery of specific guarantees under VEFA within the Protected Sector in the following form:

- either a repayment guarantee³,
- or a completion guarantee⁴.

End of the guarantees: upon completion of the property assets covered by the VEFA, as certified by an independent inspection body or a skilled professional.

2.4 Payment guarantees of the sale price of assets within the Protected Sector

The seller-builder is faced with the possible risk of the purchaser not paying its calls for funds as and when the works progress, in accordance with the provisions of the deed of sale.

In order to be protected against this default:

- The deed of sale may provide for the application of late-payment penalties.

Their rate must however be lower than 1% per month.

- An automatic termination clause upon non-payment may also be included in the deed of sale.

These termination clauses shall however be effective (confirmed by the decision of the competent court) only one month after the date of the summons to pay left unsatisfied and their effects shall be suspended should the competent court grant any time extension. Should the deed of sale be terminated, the

³ Article R.261-22 of the French Construction and Housing Code provides that this guarantee must consist in a bank guarantee (*cautionnement bancaire*) whereby a financial institution undertakes towards the purchasers to repay the payments made by each of them upon amicable or court-ordered termination of the sale in a future state of completion on the grounds of non-completion.

⁴ Article R.261-21 of the French Construction and Housing Code provides that this form of guarantee results from the granting by a financial institution of a credit facility or a guarantee (*cautionnement*) intended to pay the sums necessary for the completion of the building, it being specified that the order n°2013-890 dated 3 October 2013 relating to the financial guarantee upon sale in a future state of completion has cancelled the intrinsic completion guarantee (*garantie intrinsèque*) with respect to transactions for which an application for building permit has been filed as from 1st January 2015. The term "intrinsic" denotes a completion guarantee resulting from the inherent conditions of the operation (as these conditions are described in Article R.261-18 of the French Construction and Housing Code); the term "extrinsic" denotes a completion guarantee issued by a bank alone.

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AVOCATS

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payment by the defaulting party of an indemnity provided for in the deed of sale shall not exceed 10% of the sale price.

- The seller-builder may suspend the handover of the keys of the sold assets (and thus not proceed with the delivery) as long as the price has not been paid.
- Since the VEFA is a sale relating to a real property, the seller is, pursuant to article 2374 of the French Civil Code, a preferred creditor of the purchaser with respect to the payment of the price. This lien must be registered within two months as from the execution date of the deed of sale.

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