UK FINANCE

GREEN FINANCE AND CLIMATE RISK

A guide for the mortgage market

In association with:

TLT

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UK Finance is the collective voice for the banking and finance industry.

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FOREWORD

Green finance, climate risk and sustainability have all risen sharply up the political and regulatory agendas in the last couple of years and have become areas of increasing focus and attention for mortgage lenders.

The mortgage lending industry supports the end goal of Net Zero and the greening of the UK housing stock that will play such an important part in achieving this. We very much want to work with all the stakeholders involved – the government, regulators, industry and home-owners themselves, whether owner-occupier or landlords – to deliver this in a fair way.

There is much that needs to be done and it is helpful to understand exactly where we are in order to comprehend more fully the task ahead of us. This report sets out clearly and concisely all the policy and regulatory initiatives currently in place that will affect the market in coming months and years. We anticipate it will be a helpful source for lenders and their partners in their discussions.

Charles Roe
Director, Mortgages,
UK Finance

Green mortgages have become the poster child of green retail banking products in the UK, but despite their significant growth in the last 12-18 months, significant barriers remain. It is clear that the government considers that mortgage lenders have a key role to play in its strategy to decarbonise buildings.

However, there is still a long way to go. Transition to a mortgage market where green finance becomes the norm requires public and private sector collaboration.

Green finance represents an opportunity for the entire industry to come together with government and regulators, to develop the future landscape for the mortgage market.

We have produced this report to bring together the various legal, regulatory and policy initiatives designed to further environmental objectives and likely to impact the mortgage sector over the coming years. We hope this provides a catalyst for conversations on the future development of the green mortgage market.

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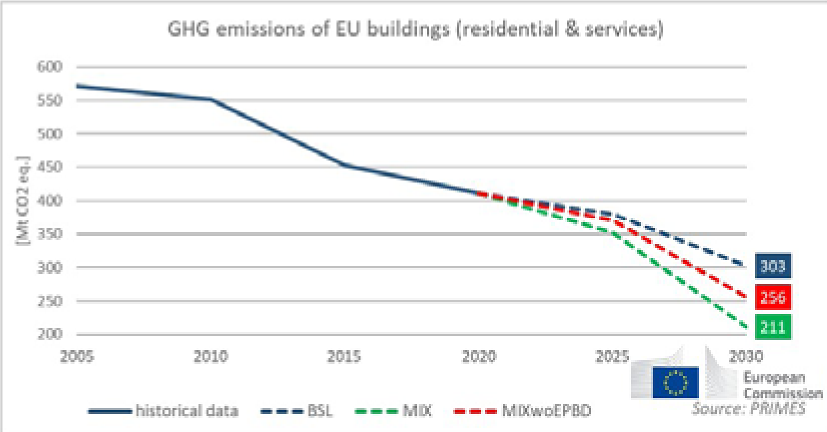
THE FRAMEWORK FOR ENERGY EFFICIENCY IN EUROPE

The European Green Deal and the Energy Efficiency Directive

With the European Green Deal, the EU has increased its climate ambition and aims to become the first climate-neutral continent by 2050. To meet the new EU 2030 climate target energy efficiency needs to be prioritised. To step up its efforts, in July 2020 the European Commission put forward a proposal for a recast directive on energy efficiency.

The proposal for the revised directive promotes ‘energy efficiency first’ as an overall principle of EU energy policy and has two key objectives:

- Contributing to reducing buildings’ greenhouse gas emissions (by 60 per cent) and final energy consumption (by 14 per cent) by 2030.
- Providing a long-term vision for buildings and ensuring an adequate contribution to achieving climate neutrality in 2050.



The proposal includes provisions that:

- Require all new public buildings to be zero emission from 2027 and all new buildings to be zero emission from 2030
- Amend the requirements for Energy Performance Certificates (**EPC**s), including a new EPC template. By 2025, all EPCs must be based on a harmonised scale from A to G. The worst-performing 15 per cent of the building stock of each member state must be upgraded from EPC grade G to at least grade F by 2027 for non-residential buildings and 2030 for residential buildings. Member states can set national minimum energy performance standards.
- Require member states to publish National Building Renovation Plans, with timelines for achieving higher EPCs, and roadmaps for achieving zero emission building stock by 2050 and for phasing out fossil fuels in heating and cooling by 2040.
- Allow member states to ban fossil fuel use in buildings and prevent financial incentives from being given for the installation of fossil fuel boilers from 2027. Where technically feasible, all new buildings will need to source 100 per cent of on-site energy from renewable energy from 2030 (2027 for public buildings).
- Require member states to remove barriers to the installation of electric vehicle recharging points for residents in multi-family buildings and require charging points to support smart charging.

The proposal was adopted by the European Commission in December 2021 and the consultation period closed in February 2022.

The EU Energy Efficient Mortgages Initiative

Since its inception in 2015, the EU Horizon 2020-funded Energy Efficient Mortgages Initiative (**EEMI**) has been the catalyst for the growth of a new, integrated, multi-stakeholder energy-efficient mortgage (**EEM**) ecosystem.

The EEMI's work is built around five key pillars:

EEM Product Framework	The EEMI has set out the key elements of an EEM product framework, including: • a definition of an EEM; • property valuation guidelines; and • building energy performance measurement parameters.
Data	The EEMI has designed an infrastructure to manage the collection, processing and disclosure of data on EEM and conducted in-depth data collection and analysis in connection with the link between energy efficiency and credit risk.
Building confidence through transparency	The EEMI has launched the Energy Efficient Mortgage Label (EEM Label). The EEM Label provides access to relevant, timely and transparent information on banks' loan portfolios through the Harmonised Disclosure Template. The EEM Label is a quality benchmark which supports confidence in EEM, catalyses consumer demand, drives enhanced asset quality and facilitates investor due diligence.
National hubs and consumer research	The EEMI has established national market hubs to adapt and roll-out the EEM ecosystem across European jurisdictions, as well as consumer research to understand consumer preferences and guide the design of the customer journey.
Keeping pace with EU legislation	The EEMI provides a bridge between policy ambition and market reality, providing a mechanism for financial institutions to align with the EU Taxonomy for sustainable economic activities.

The Energy Efficient Mortgage Label

The EEM Label is designed to identify energy efficient mortgages in lending institutions' portfolios, which are intended to finance the purchase, construction and/or renovation of residential and commercial buildings, with a focus on building energy efficiency.

The EEMI define an EEM as: *"a mortgage intended to finance the purchase/construction and/or renovation of both residential and commercial buildings where there is evidence of: (1) energy performance which meets or exceeds relevant market best practice standards in line with current EU legislative requirements and/or (2) an improvement in energy performance of at least 30%. This evidence should be provided by way of a recent EPC rating or score, complemented by an estimation of the value of the property according to the standards required under existing EU legislation or equivalent legislation outside the EEA. It should specifically detail the existing energy efficiency measures in line with the EEM Valuation & Energy Efficiency Checklist."*

To apply for the EEM Label, lenders must certify they comply with the EEMI definition of an Energy Efficient Mortgage and commit to providing regular information following the Harmonised Disclosure Template:

"The EU Taxonomy will act as a compass for sustainable economic activities and therefore will be an important guide for banks in funding the Renovation Wave our future generations need. The identification of taxonomy-aligned assets is essential if we want to mobilise and scale-up investment in a carbon-neutral future, as well as green recovery from the pandemic. Through its efforts to deliver a green ecosystem around EEM, green covered bonds and green European Secured Notes (ESN), our industry is a driver for change for our economy and remains absolutely committed to ensuring the transition is not only sustainable but leaves no one behind."

EMF-ECBC Secretary General, Luca Bertalot

The framework for energy efficiency in the UK

In October 2021, the UK government published its Heat and Buildings Strategy (the **Strategy**). Decarbonising energy used in buildings forms a key part of the government's Clean Growth Strategy and underpins the prime minister's Ten Point Plan for a Green Industrial Revolution. This requires improvements to the energy efficiency of buildings, changes to the way we heat and cool our buildings and improving the performance of energy-related products.

The Strategy brings together the government's work on energy efficiency and clean heat. It seeks to ensure that the UK has a consistent and coherent approach across different markets, buildings and occupancy types and a credible pathway to achieving Net Zero targets.

There are several aspects of the Strategy that are of particular interest to the mortgage market:

- **Minimum energy efficiency standards for property.** The Strategy sets out the government's ambition to build on its 2020 consultation on improving the energy performance of privately rented homes, using minimum standards to ensure the UK housing stock is on track to meet EPC band C by 2035 where practical.

- **Disclosure requirements and targets for lenders.** In 2021, the government consulted on improving home energy performance through lenders. This included proposals to introduce mandatory disclosure requirements for mortgage lenders on the energy performance of homes on which they lend, and on setting voluntary targets to improve the energy performance of their portfolios to an average of EPC band C by 2030. The consultation proposed making these targets mandatory if insufficient progress is being made. In the government's view, this would encourage significant product innovation and new partnerships and drive the development of a green home finance market to support homeowners to make energy efficient improvements. These measures remain under consideration.

- **Developing supply of green finance.** Different types of buildings – with different users, owners and heating needs – will require different types of financial support to decarbonise. The government wants to challenge industry to innovate and improve the affordability of energy efficient technology and see developing new financing models for consumers as one mechanism to achieve this, with mortgage lenders and other organisations having a key role to play. The Strategy recognises that there is investor interest in green finance products globally, but this has yet to be converted into established financial products in the UK.

  Building on the outputs and learnings from the Green Home Finance Innovation Fund competition, the Strategy announces the launch of a further programme to provide grant funding to stimulate more innovation in the UK green home finance market. This may include support for UK retail lenders to design, develop and pilot a range of finance propositions that encourage domestic installation of energy efficient measures and low-carbon heat. This funding programme will formally launch by spring 2022.

- **The role of mortgage lenders as a catalyst for change.** For mortgaged properties, the government sees lenders as uniquely placed to influence homeowners, landlords and businesses to undertake energy efficient property upgrades at key trigger points in the mortgage lifecycle such as the point of purchase, renovation or re-mortgage.

- **Link between energy efficient home improvements and risk of default.** The Strategy notes emerging evidence suggesting a link between investments in energy efficiency and low-carbon technology on the one hand and property values and a lower risk of default on the other.

Impact of the Strategy on the mortgage market

Understandably, when the Strategy was launched it was the risk of "energy-efficiency property prisoners" and potential financial exclusion that dominated the headlines across the mainstream and trade press.

It is clear from the Strategy that there are considerable hurdles to overcome, particularly to boost the financing of energy efficient retrofits in the UK, and that there is no one-size-fits-all solution to the decarbonisation of buildings.

However, these risks and challenges are not insurmountable. The Strategy provides a starting point, but it is clear a more complete and coordinated plan is needed between government, regulators and industry to achieve the ultimate goal of upgrading all UK property to an EPC rating of C.

To date, one of the key challenges to growth and development of the market has been consumer demand. One of the ways the Strategy seeks to address this is through a combination of government support for advice to homeowners on how they can improve their building's energy efficiency (for example, through the Simple Energy Advice online platform) and introduction of minimum property standards.

In addition to the measures set out in the Strategy, there are other potential steps that could be considered to help accelerate green innovation in the mortgage market (as recognised by the Climate Financial Risk Forum). These include:

- reflecting actual household energy costs (one of the largest unavoidable outgoings every mortgage borrower incurs) differently in mortgage applications, in which case lenders may be able to justify higher lending to low energy cost properties;
- creating a high-level framework of market standards and guidelines for a green mortgage market;
- freeing up capital that banks can reinvest in additional green mortgages and loans.

The framework for energy efficiency in the devolved nations

Wales

In 2019 the Welsh government published its Energy Efficiency Strategy (**EES**), which sets out its vision for a more energy efficient Wales by 2025. It looks to ensure that Wales is in the best possible position to realise its full energy efficiency potential and become a major exporter of energy efficiency technology and know-how.

The EES recognises:

- the need to raise awareness of the value of energy efficiency compared with other investment, to improve the quality of information provision and to build trust in it;
- the value of partnerships between the public and private sectors.

Grant and loan funding for owner occupiers	• In line with the Wales Infrastructure Investment Plan, the Welsh Government provides grant funding for those households living in deprived communities and those in the most energy inefficient homes and on the lowest incomes. • For other householders, the Welsh Government's Home Improvement Loans Fund enables householders to take out finance to improve their homes. This scheme is delivered by local authorities and enables short-to-medium term loans to be provided to owners of substandard properties providing they pass affordability criteria and are restricted in their access to other sources of finance. • Loans are also available to bring empty houses back into use as homes - including splitting them into flats - for sale or rent. The improvements made using these loans will include energy efficiency improvements.
Standards for the social rented sector	• All 220,000 social homes had to achieve the Welsh Housing Quality Standard by 2020 – ensuring that these homes met an EPC rating D.
Standards for the private rented sector	• Rent Smart Wales is a relatively new registration and licensing scheme aimed at driving up the standards in the private rental sector. This is being used to raise awareness by landlords, agents and tenants of their responsibilities. It also allows councils to fully identify all of the private rental properties within their local area, making it easier for them to work closely with landlords to ensure high rental standards are being met, such as those relating to energy efficiency. • From April 2018, private domestic and non-domestic landlords have needed to ensure that their properties reach at least an E EPC rating, or to have installed those improvements that could be funded using available finance or subsidies available to pay for them, before granting a new tenancy to new or existing tenants.

Northern Ireland

The Energy Management Strategy and Action Plan to 2030 (for Northern Ireland Central Government), aims to support and significantly accelerate actions to maximise exploitation of energy efficient opportunities in current and future assets.

To date, the focus on improving the energy efficiency of the housing stock in Northern Ireland has concentrated on new housing. For example, in 2020 the law changed in Northern Ireland to require that all new housing must be built as nearly-zero energy buildings (nZeb). These changes are designed as interim steps to raise energy efficiency standards for new builds and new minimum insulation values.

Scotland

Energy efficiency standards by housing sector

Published in October 2021, the Scottish government's 'Heat in Buildings Strategy – achieving net zero emissions in Scotland's buildings' (the **Strategy**) sets out its vision for the future of heat in buildings and the actions that the Scottish government is taking in the property market to deliver its climate change commitments, maximise economic opportunities and ensure a just transition.

The Strategy sets out a pathway to net zero emissions buildings by 2045 and details a series of near-term actions and longer-term commitments to accelerate transition of Scotland's building stock. We have summarised below the range of measures proposed across the different aspects of the housing sector:

All tenures	• Where technically and legally feasible and cost-effective, by 2030 a large majority of buildings should achieve a good level of energy efficiency, which for homes is at least equivalent to an EPC band C, with all homes meeting at least this standard by 2033.
Standards for owner occupiers	• The Scottish government will consult on detailed proposals for minimum energy efficiency standards for all owner-occupied private housing. It is envisaged that these will be set at a level equivalent to EPC C. • It is proposed to introduce regulations from 2023 – 2025 onwards, and that all owner-occupied domestic buildings would be required to meet this standard by 2033.
Standards for the social rented sector	• The Energy Efficiency Standard for Social Housing (EESSH) was introduced in 2014. As a result, 89 per cent of homes in the social rented sector have already achieved EPC D or above. • Social landlords are working towards the second EESSH2 milestone for all social housing to meet, or be treated as meeting, EPC B, or be as energy efficient as practically possible, by the end of December 2032. • The Scottish government has indicated its intention to review the EESSH2 standard, with a view to strengthening and realigning it with wider net zero requirements.
Standards for the private rented sector	• Introduction of new regulations in 2025, requiring all private rented sector properties to reach a minimum standard equivalent to EPC C by 2025 where technically feasible and cost effective, at change of tenancy, with a backstop of 2028 for all existing properties.

Scottish government schemes to support improvements to the energy efficiency of homes

The Scottish government has already introduced a variety of schemes to support home-owners to make energy efficient improvements to their homes, delivered by the Energy Saving Trust (in partnership with advice providers and energy companies) on behalf of Home Energy Scotland. The schemes, which are particularly targeted towards those in fuel poverty include:

Home Energy Efficient Programmes for Scotland (HEEPS)	Through HEEPS the Scottish government fund local authorities to develop and deliver energy efficient programmes (mainly solid wall insulation) in areas with high levels of fuel poverty. This funding is blended with energy company obligation funding, owners contributions and funding from registered social landlords who may choose to insulate their homes at the same time.
Energy Efficient Scotland: Warmer Homes Scotland	The national scheme was launched in September 2015 and is worth at least £16 million per year for up to seven years. It is available to private sector households (tenants or owner-occupiers) who are living in or at risk of living in fuel poverty and meet the qualifying eligibility criteria.
Home Energy Scotland Loan	Funding up to £38,500 per home is available to owner-occupiers, with up to £15,000 available for a range of energy efficiency improvements and an additional £17,500 available for home renewables systems or connections to an approved district heating scheme powered by a renewable energy source. The loan is interest free and available to owner-occupiers in Scotland. The loan repayment period varies based on the amount borrowed, with those taking out higher-value loans able to pay them back over ten years.

Additional investment is planned, with a further £1.8 billion of capital funding pledged over the next five years to accelerate energy efficient upgrades.

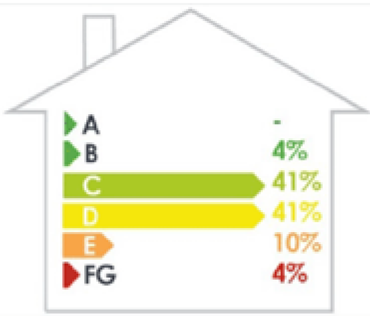
Reform of the regulatory framework

Alongside these measures (and subject to consultation and to limits on devolved competence), the Scottish government will introduce primary legislation that provides the regulatory framework for zero emissions heating and energy efficiency, and underpinning powers to support this transition and the wider Heat in Buildings programme.

For homes the Scottish government is developing a regulatory framework for energy efficiency and heat supply that will: (i) reform Energy Performance Certificates; (ii) address both heat decarbonisation and energy efficiency; and (iii) increase clarity and pace.

Of particular interest to lenders will be the Scottish government's consultation on reform of the existing EPC which considers options to include three indicators as a basis for future standards: (i) an indicator for energy efficiency which will recommend measures needed to reduce demand for heat; (ii) an indicator for heating emissions which will recommend the most appropriate heating system; and (iii) an indicator for the cost of heating.

Energy efficiency of Scotland's homes by EPC rating (source Scottish House Condition Survey, 2019)



Outlook

The Strategy forms the foundation of the Scottish government's work. A refreshed Energy Strategy and Energy Just Transition Plan is expected in spring 2022, together with a bespoke Public Engagement Strategy, which will form the core of the Scottish government's plans to encourage home upgrades.

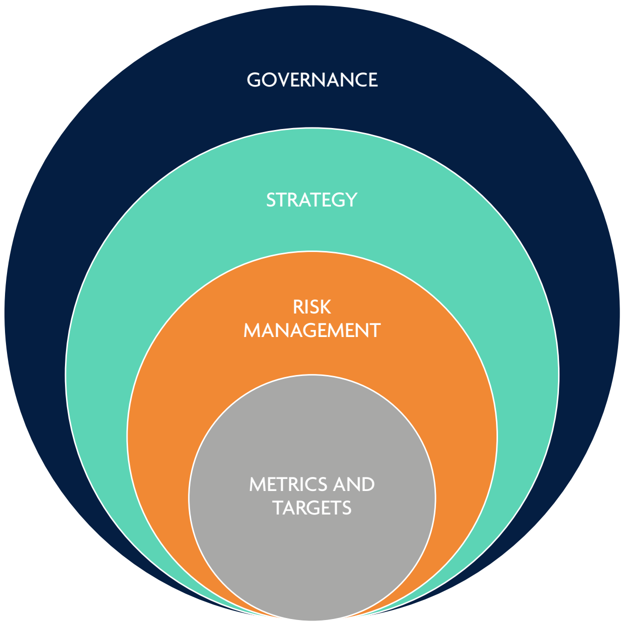
The Strategy leaves a lot of questions unanswered. In particular, although it acknowledges the significant costs involved in meeting the standards to be introduced, it lacks detail on how this is to be funded. The promised Scotland Green Heat Finance Taskforce maybe key to this in encouraging private sector investment and developing partnerships between the public sector, heat decarbonisation experts and the financial services sector. It's likely that mortgage lenders will need to play a key role in this, both in the residential and buy-to-let markets.

Prudential regulation and climate risk management: the view from the PRA

In 2018, the PRA produced a report on the impact of climate change to the UK banking sector. The report found that the UK banking sector is exposed to physical risks, in particular through the potential impact on mortgages to properties with high flood risk, and to transition risk, for example through banks' financing of companies with carbon-intensive assets at risk of becoming 'stranded' (i.e. have suffered from unanticipated or premature write-downs, devaluation or conversion to liabilities).

In April 2019, the PRA became the first prudential regulator to publish a comprehensive set of expectations in Supervisory Statement 3/19 (SS3/19) for how banks and insurers should enhance their approaches to managing the financial risks from climate change. These expectations are designed to ensure firms adopt a strategic, holistic and ambitious approach to managing climate-related financial risks.

The TCFD recommendations are centred around four core organisational themes.



For mortgage lenders in scope of PRA regulation (i.e. those with a banking licence) the PRA's key expectations were for firms to:

1. embed climate-related financial risks into their governance framework;
2. under the Senior Managers Regime (SMR), allocate responsibility for identifying and managing climate-related financial risks to the relevant existing Senior Management Function (SMF), and ensure that these responsibilities are included in the SMF's Statement of Responsibilities;
3. incorporate climate-related financial risks into existing risk management frameworks;
4. undertake longer-term scenario analysis to inform strategy and risk assessment; and,
5. develop an appropriate approach to climate disclosure in line with the TCFD framework.

What comes next?

The PRA's expectation was that every firm should be able to demonstrate a proportionate understanding and management of climate-related financial risks from the end of 2021. Since the beginning of this year, the PRA has started to supervise actively firms against the expectations set in SS3/19 and we will start to see the assessment of climate-related financial risks included in all relevant elements of the supervisory cycle.

There are some areas where the PRA is likely to go further and by the end of 2022 the PRA intends to provide an update on the following:

- **Regulatory capital:** the PRA intends to set out its views on whether changes to the regulatory capital regimes, or their application, are required to address climate related financial risks.
- **Regulatory returns:** As climate moves into core supervision it will become increasingly important to get regular and relevant data. The PRA will consider what regular data supervisors could require from firms and if there is need to obtain this information via regulatory returns.
- **Scenario analysis:** The PRA and wider Bank have not yet set out future plans for climate scenario analysis beyond the Climate Biennial Exploratory Scenario (CBES) and existing expectations in SS3/19. Climate scenario analysis is a key tool that informs both micro- and macro-prudential considerations. An update will be provided on the future of climate scenario exercises after the results from the CBES and further lessons from firms' approaches to scenario analysis have been considered.
- **Transition plans:** In order to manage their climate-related financial risks and support the transition to Net Zero, many firms have, or are considering, setting out transition plans that align their activities with climate targets. The government's roadmap to sustainable investing notes the Sustainability Disclosure Requirements (SDR) will 'require disclosures on transition plans'. These plans will also be of interest to the PRA, particularly where it sets out how firms intend to manage their activities in line with transition pathways. They will also be useful in helping the PRA understand what implications firms' plans may have on the economy wide transition and assessing progress on the transition at a firm and system level. The PRA will provide an update at a later date on how such plans will be considered in the supervisory process.

Conduct regulation and climate risk management: the view from the FCA

The FCA's climate strategy is centred on the five 'Ts'

Transparency	Promoting good and consistent disclosures along the investment chain.
Trust	Ensuring that the market delivers sustainable finance instruments and products that genuinely meet investors' sustainability preferences – and are seen to do so.
Tools	Government, regulators and industry working collaboratively to share experience, develop consistent guidance and tools and provide mutual support as we confront the challenges of climate change.
Transition	Developing the FCA's role in supporting a market-led transition to a more sustainable future.
Team	Embedding climate and other sustainability considerations in the way that the FCA functions as an organisation.

In its report "*Climate Change Adaptation*" the FCA noted that while lenders were taking into account climate-related risks when feeding through into their credit risk functions, it added "*banks need to be taking a strategic and organisation-wide approach to climate change, including both their mortgage and financing activities*".

In its February 2022 Dear CEO Letter setting out its strategy for the Retail Mortgage Lenders portfolio, the FCA provides an update on its work relating to its environmental, social and governance strategy.

It states:
"We expect retail mortgage lenders to play their part in helping the economy adapt to a more sustainable long-term future. We've seen encouraging steps taken by some retail mortgage lenders, for example, providing green mortgages. But ultimately, a firm's own governance and culture will be critical drivers and enablers of its performance on environmental and climate matters. Since wider environmental and social matters are increasingly central to economic and financial decision making, our work too must encompass ESG considerations beyond climate change."

So, some further encouragement for mortgage lenders that already have or plan to launch green mortgage products, but also further emphasis on the importance of risk management, governance and culture. This is perhaps in recognition of the January 2022 PRA Dear CEO letter addressed to UK deposit takers which stated:

"We have observed that most firms are focussed on the business opportunities presented by climate change and remind firms that climate change also presents an increasing business risk that is foreseeable and requires action now."

Conduct risk and the green mortgage market

- **Transparency:** appropriate disclosures to consumers will help them make more informed decisions about products and services – protecting them from choice of unsuitable products.
- **Trust:** it is important that consumers can trust the information provided about green mortgage products and that products marketed with a sustainability and environmental focus are described accurately and any assertions made about their goals are reasonable and substantiated.
- **Energy-efficient property prisoners:** borrowers are not "trapped" in older less energy efficient homes due to changes in product availability.
- **Fair value:** pricing practices do not inadvertently result in customers without the means to undertake energy efficient home improvements paying higher prices.

Climate risk

The Environment Agency estimates that 5.2 million homes and businesses in England are at risk of flooding and coastal erosion. Terrafirma's National Ground Risk Model estimates that 4,000 domestic properties are currently considered to be at substantial risk from coastal erosion across England, Wales and Scotland. This figure is expected to rise to around 23,000 by 2100.

The mortgage sector needs to consider the impact of coastal erosion and flood risk on housing valuations. In a recent report by the Basel Committee on Banking Supervision, concerns were raised for households exposed to severe flood risk, since this can affect house prices.

The Bank of England's discussion paper published in 2021 highlights that *'around ten per cent of the value of mortgage exposures in England is on properties in flood-risk zones'*. Lenders could face greater losses than anticipated if values of collateral are reduced.

The FCA's ongoing monitoring of the mortgage sector has indicated that lenders are taking into account climate-related risks as they feed through into credit risk and a risk to the collateral held against loans. However, the FCA has not observed significant widespread changes in lenders' behaviour in response to climate change outside their usual risk calculations, noting that mortgage lenders need to:

"be taking a strategic and organisation-wide approach to climate change, including both their mortgage and financing activities."

The FCA has particular concern that climate change will impact on the equity release market, noting:

"We have also observed that lenders have differing approaches to offering equity release for properties in flood zones. Time elapsed since the last flooding, the frequency of flooding, valuation of the property and availability of insurance can affect whether a lender will consider a property eligible for equity release. As the likelihood and severity of flooding increases due to climate change, we are concerned that more consumers will be left unable to access equity release as an option."

The Climate Financial Risk Forum

The Climate Financial Risk Forum (**CFRF**) co-chaired by the FCA and the PRA is intended to build capacity and share best practice across financial regulators and industry to advance the financial service sector's responses to the financial risks from climate change.

The CFRF focuses on four areas:

- Disclosures
- Scenario analysis
- Risk management
- Innovation

In June 2020 the CFRF published a guide which aims to help financial firms understand the risk and opportunities that arise from climate change, and provides support for how to integrate them into their risk, strategy and decision-making processes.

The CFRF recognised:

- The need for new financial instruments to unlock finance needed to retrofit housing in the UK and the importance of expanding the green mortgage market and other products for retrofitting requiring both additional producer "push" and retail consumer "pull".
- The use of regulatory levers in accelerating the green mortgage market, in particular implementing the LENDERS Project recommendations to include actual energy costs in the loan to income ratio. The LENDERS (Levering Economics for New Drivers to Energy Reduction & Sustainability) project proposes to better reflect actual household energy costs – one of the largest unavoidable outgoings every mortgage borrower incurs – into mortgage applications, in which case lenders may be able to justify higher lending to low energy cost properties and make energy performance a fundamental part of mortgage lending, and ensure that this changes the cost of capital for "green" homes.
- The benefits of developing a pipeline of green asset-backed/mortgage-backed securities, which can play an important role in freeing up capital for banks to reinvest in additional green mortgages and loans.

What comes next?

The FCA's Climate Adaptation Report, published in late 2021, identifies a range of future FCA ESG publications on the horizon:

- In spring 2022, the FCA is expected to publish a feedback statement and consultation paper on the Sustainability Disclosure Regime and product labels.
- In summer 2022 we will see the FCA publish its first TCFD-aligned report considering the FCA as an operating entity and as a regulator, alongside its Annual Report.

GREEN MORTGAGES: THE INTERMEDIARY PERSPECTIVE

Lender-led research suggests an increase in enquiries from consumers to mortgage intermediaries about green mortgages. Research from Leeds Building Society published in Mortgage Solutions found that four in five mortgage advisers had seen in increase in enquiries in green mortgages in the three months leading up to the end of 2021, compared with the prior 12 months. Nearly all those surveyed expected demand for green mortgages to increase, with half predicting demand to grow significantly.

It's perhaps not surprising, given the changes to housing policy outlined in this paper, that green mortgages have quickly become one of the mortgage industry's most talked about topics, sitting high on the agenda for mortgage intermediaries as well as lenders. Yet this does not appear to be translating into high volumes of sales. A **survey** conducted by Countrywide Surveying Services in late 2021 showed found that 94 per cent of the intermediaries surveyed were yet to "sell" a green mortgage.

One of the early challenges for the intermediary market was lack of choice. Even looking back to 2020 there were limited green mortgage products in the market. With an increasing number of consumers making environmentally friendly and carbon neutral choices, there is no question that this is going to be an important topic of conversation in any mortgage advice process.

To achieve this, it is important that mortgage intermediaries feel comfortable discussing green mortgages and know when to recommend them. In the residential mortgage market, much of the advised sales process is guided by the FCA's Mortgage Conduct of Business Rules (**MCOB**). The key obligation on a mortgage adviser is set out in MCOB 4.7A.2R:

"If a firm gives advice to a particular customer to enter into a regulated mortgage contract, or to vary an existing regulated mortgage contract, it must take reasonable steps to ensure that the regulated mortgage contract is, or after the variation will be, suitable for that customer."

Where a firm's product range includes more than one regulated mortgage contract that is appropriate to the needs and circumstances and the firm advises a customer to enter into a regulated mortgage contract which is not the cheapest of those contracts in the firm's product range which are appropriate to the needs and circumstances of the customer:

"The firm must explain to the customer why it is advising the customer to enter into that regulated mortgage contract rather than any other cheaper regulated mortgage contract in the firm's product range which is appropriate to the needs and circumstances of the customer" (MCOB 4.7A.23AR).

Anecdotally we understand that there is some nervousness about the extent to which an intermediary can consider a customer's preference for mortgage product that has environmental benefits (for example a carbon neutral mortgage) even where that product is not necessarily the cheapest that would otherwise meet the customer's needs and circumstances.

Green mortgages (and improving the energy efficiency of homes more generally) also needs to become a core part of the syllabus for key mortgage adviser qualifications, such as CeMAP. This is important because advisers have a central role to play in encouraging energy efficiency and having the conversations with customers both about changes to the regulatory landscape in the housing market and minimum energy efficiency standards, but also how to access finance for that work at the appropriate time. As the main point of contact between customers and lenders, mortgage intermediaries are best placed to help borrowers to understand their options.

Increasing uptake in green mortgages will prove key in accelerating work on improving the energy efficiency of homes and it is clear that mortgage intermediaries have a central role to play in the future development of this market.

GREEN MORTGAGES: THE RESIDENTIAL MORTGAGE MARKET

Homeowners in the UK who are looking for a green mortgage have more options than ever before. The opportunity for lenders in the residential mortgage market is huge. The UK Committee on Climate Change estimates that £250 billion needs to be invested in UK home upgrades by 2050, which means there is the potential for significant capital flows in green mortgages in the coming years.

The Green Mortgage Hub, launched by the Green Finance Institute (**GFI**) in 2021, lists 31 green mortgage products available across the market:

Yet, we understand there are many challenges accelerating uptake from a home-owner perspective:

- **Familiarity with EPC ratings and what they mean:** many homeowners do not know the EPC rating for their home because to date this has been of lesser importance in the home-buying process. Research has shown that many home-owners do not understand what makes a home an 'A' rating.
- **Barriers to undertaking the work:** it can be difficult for homeowners to identify in advance how or what the energy efficient improvements would look like and the work is perceived to be high cost. There can also be practical limitations associated with the home itself.
- **Motivation:** because energy efficient home improvement work can often come with longer-term financial benefits, but with limited immediate financial impact on homeowners motivation to undertake the work.
- **Dream home:** for homeowners that seek a historic home with lots of character, improvements that conflict with that vision of an 'ideal home' are unlikely to be made.

Across the residential mortgage market, we have typically seen products that fall into two categories:

1. **Green home discount mortgage:** offers a discounted interest rate on the mortgage when mortgaging an A or B rated home. Offers a tangible, monetary incentive towards buying an energy efficient home.
2. **Green home improvement mortgage:** enables the borrower to borrow money to make energy efficient improvements to their home (typically structured as a further advance). Often results in monthly payments which are lower than for an equivalent personal loan (because the monthly payments are spread over a longer term).

However, we are also beginning to see new structures emerge. In 2021 we saw the launch of the UK's first mortgage to be certified as carbon neutral by the Carbon Trust. The Carbon Trust measured the carbon footprint of providing mortgages, which includes the emissions generated throughout the mortgage lifecycle (calculating the emissions per mortgage). The mortgage provider committed to keep reducing this carbon footprint yearly and to offset any remaining emissions by investing in projects that reduce emissions by the same amount as those generated by providing the mortgages.

We are also seeing an increasing number of mortgage providers partner with third-party tools to help customers reduce emissions and save money – in particular, tools which enable the customer to carry out a home energy check and provide a personalised report and action plan to improve the energy efficiency of their home.

To support mortgage providers, the GFI recently launched a 'Lender's handbook on green home technologies' (the **Lender's Handbook**). The Lender's Handbook is a practical guide to help financial institutions and other understand the key energy efficiency, heating, microgeneration and resiliency technologies available to homeowners. The Lender's Handbook uses a snapshot of each technology, including the current costs, carbon savings and benefits, as well as profiling the main funding options, quality assurances and guarantees to protect customers. A copy of the Lender's Handbook can be found here.

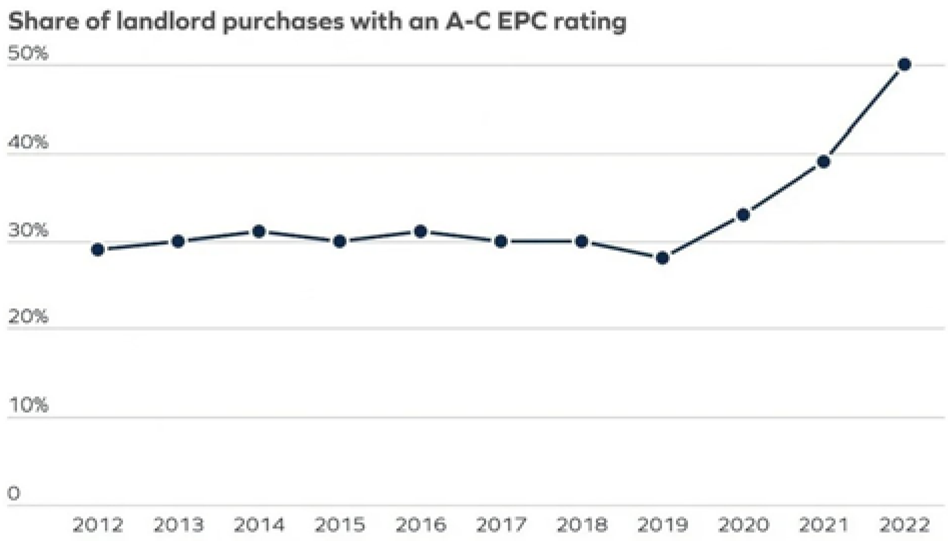
GREEN MORTGAGES: THE BUY-TO-LET MORTGAGE MARKET

In 2015 the government introduced the Minimum Energy Efficiency Standard **MEES**) that requires landlords to reach EPC rating of C or above. Under the proposed changes, by 2025 all newly rented properties will have to have reached this target. This will be extended to all rental properties by 2028.

This presents significant challenges across the buy-to-let mortgage market:

- A significant proportion of housing stock across the UK is unlikely to be rated C or above. So, from 2025 landlords will not be able to begin a new tenancy on these properties, without actively making improvements.
- There are likely to be significant costs for landlords associated with such work. Estimates of the cost of retrofitting the average UK home vary, but typically range between £5,000 - £10,000.
- Renovation work is also likely to impact on occupation of the property and void periods. The more extensive the renovation work required, the more likely it is that the property would have to be vacant while the improvements are made, impacting on rental income and continuity of tenants.

A recent report by Hamptons Estate Agency showed that although the proposal remains at the consultation stage, many landlords are already hedging their bets regarding introduction of the new standards. Half of all homes bought by investors so far this year had an EPC rating of C or above, representing a record high.



Source: DCLG and Hamptons "New Landlords Adapt to Incoming EPC Standards"

In response we have seen a growing number of lenders offering lower mortgage rates to landlords buying more energy-efficient properties.

Yet there is more that can be done. Research commissioned by Shawbrook Bank and published in its White Paper 'Confronting the EPC Challenge' identified a clear lack of knowledge and understanding by landlords in the private rental sector over how much the MEES will impact landlords individually and how much the necessary works will cost to carry out.

Buy-to-let lenders have a key role to play in supporting landlords through these changes, both in educating landlords on the potential impact to their portfolio and providing support to finance the necessary works.

WHAT COMES NEXT?

The PACE model: the future?

The property assessed clean energy (**PACE**) model is a mechanism for financing energy efficiency and renewable energy improvements on private property. PACE programs allow a property owner to finance the upfront cost of energy or other eligible improvements on a property and then pay the costs back over time through voluntary assessment. The unique characteristic of PACE assessments is that the assessment is attached to the property rather than an individual.

Use of this financing model for energy efficiency improvements allows a property owner to implement improvements without a large upfront cash payment.

A PACE model would mean the debt is tied to the property rather than the property owner(s). Consequently, the repayment obligation may transfer with property ownership if the buyer agrees to assume the PACE obligation and the new first mortgage holder allows the PACE obligation to remain on the property. This can address a key disincentive to investing in energy improvement if a homeowner thinks they may not stay in the property long enough for the resulting savings to cover the upfront costs.

Property owners who choose to adopt a PACE funding model repay their improvement costs over a set time period – typically ten to 20 years – through property assessments.

Although an attractive option, the PACE model has its critics, including in relation to the complexity of the repayment mechanism.

Stamp duty incentives: an alternative?

One alternative is an idea first advanced by the Energy Infrastructure Group (**EIG**) to use stamp duty and council tax as incentives to encourage energy efficient property improvements.

The EIG use an example of a two-bedroom end-of-terrace property with an agreed sale price. At present, the buyers would pay stamp duty of £2,500. Under the system proposed by EIG, on the same property buyers would pay £847 if the property had an EPC rating of A, rising to £4796 if it had an EPC rating of E. To encourage energy efficient improvement work, the buyers would be able to gain a rebate if they undertook energy improvements within the first two years which succeeded in improving the property's EPC rating.

Such a proposal has its challenges though:

- unlike a scheme, such as the road tax scheme, it does not take into account ability to pay; and
- the scheme is based on the EPC rating, which is reflective of energy cost rather than carbon emission.