HORIZON
from
SKADI

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In this month's HORIZON:

- **Green Mortgages** – a look at green mortgages, the capital-relief benefits they offer to the banks, and associated issues.

Introduction

Europe's Energy Performance of Buildings Directive (EPDB) aims to improve the energy efficiency of buildings and has set the goal of achieving a fully decarbonised building stock by 2050. It has also set a very ambitious **target** of cutting greenhouse emissions in the building sector by 60% by 2030.

However, with the majority of buildings in the EU built before 2000 and exhibiting poor energy performance there is a mountain to climb. Deutsche Bank estimates that in Germany alone, over 60% of homes require green renovations, costing between EUR740 billion and EUR1 trillion.

Green Mortgages

Increasingly banks are offering their customers green mortgage products. These can offer preferential terms for mortgages **secured** against energy efficient properties. Some products offer incentives for sustainable retro-fittings. For the borrower, green mortgages offer reduced rates for initial terms compared with traditional mortgage products. That said, as they are a relatively niche product, they do not always offer the cheapest rate on the market.

In the UK, to qualify for a green mortgage, properties will need a high Energy Performance Certificate **(EPC)** score, typically a "C" rating or above. More on EPCs later!

Securitisation

For banks, who are the main lenders, green mortgages offer capital relief. For example, this month Deutsche Bank (DB) unveiled a deal with the European Investment Bank (EIB) that allows it to offer discounts on green mortgages. The EIB will guarantee a EUR150m mezzanine tranche of the total EUR600m and will allow DB to reduce its capital requirements. For now, the **capital reduction benefits** form the main incentive driving growth in the sector.

Issues from a retail perspective

We can see several issues relating to the above in relation to **fraud**, especially around the issuance of EPC certificates. [As an aside, a cursory web search by the SKADI team leads us to worry that EPC certification may be a "side hustle" for some of the people listed as offering the service]. The EPC rating system is in our view a significant area of risk. With the potential squeeze on landlords, who could be required to raise the ratings of their housing stock, coming at the same time as the wider uptake of green mortgages enabling consumers to access cheaper borrowing and banks to get preferential capital treatment on their balance sheets. The risk of beneficial EPC ratings being fraudulently obtained is increased.

Issues from a bank perspective

A mortgage, is a mortgage, is a mortgage! Whilst we laud the efforts of policy makers to encourage a transition to sustainable housing, we can't help but feel that, like a lot of ESG policies, they were far easier to discuss in the previous low interest rate environment. The reality, as the rubber hits the road, is that someone with a green mortgage has exactly the same **default risk** as someone without! Hence, if a bank is allowed to extract a lower requirement for green mortgages, they are obviously going to utilise this, but may well be storing up larger issues down the line when defaults start to rise.

There is also the issue of what to do with the current residential real estate portfolios. The danger is that the banks remain saddled with property assets that aren't living up to regulatory requirements. As ING economist Carsten Brzeski points out in a Bloomberg article this month… "The big picture across Europe is that "there isn't enough money" to bring the housing stock in line with the bloc's targeted environmental standards […] "You can't force homeowners to do renovations.""

A further issue for banks is that they may be **incentivised**, given the regulatory tailwinds, to classify as many mortgages as possible as "green" to benefit from the capital relief that this will bring.

Issues for control functions

For control staff at Wholesale Financial firms, we feel the three following areas should be considered:

- Monitoring: When green mortgages are issued, especially with regard to the upgrading of existing housing stock, how is this measured on an on-going basis? Are there certain milestones that need to be met to ensure the mortgage remains "green" (and thus eligible for reduced capital requirements)?

- Third Party Risks: What steps are in place to monitor third parties, such as EPC assessors, to ensure they remain accredited.

- Static Data: There will be additional data field with respect to a green mortgage, such as “current EPC” and “targeted minimum EPC”. Whilst these will need to checked on setup, just as important will be who has access to these going forward. Ensuring an audit trail of any changes will be vitally important to ensure that desks to not have the opportunity to “game” the system.

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Listen in on this month’s podcast to hear Nic and Damian’s thoughts the topics above.

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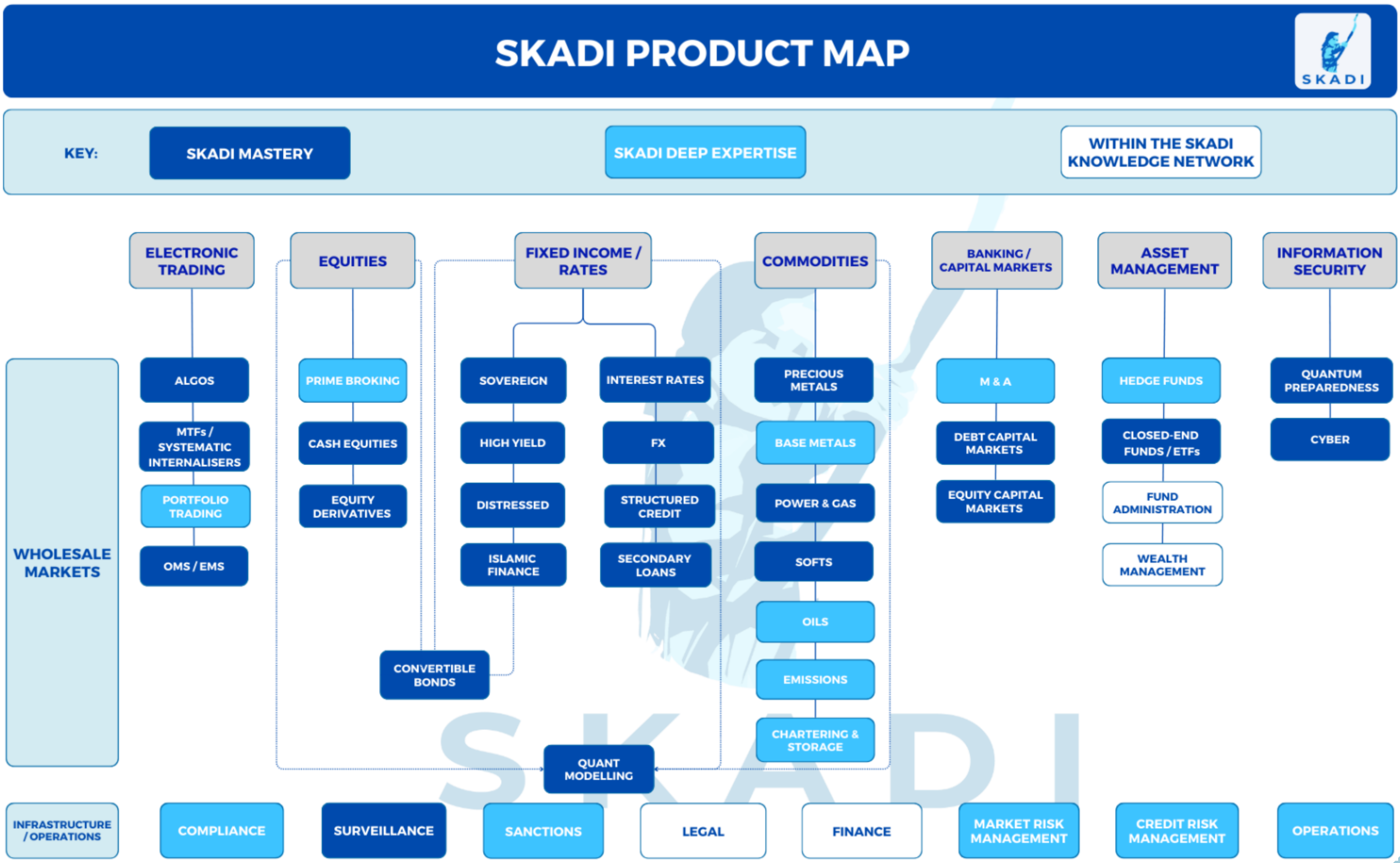

“Whether we’ve worked as traders or in operations everyone you’ll speak to at SKADI has front-line knowledge and a deep understanding of financial products”

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