Decarbonisation of the UK Economy and Green Finance Inquiry

Building Societies Association Response

Restricted
24 July 2019

Summary

- Building societies have a strong interest in good quality housing, which includes energy efficient properties
- Striking the right balance between decarbonisation, the speed and the cost of it is important
- Sharing data about energy efficiency assessments would be helpful for lenders
- Building societies are working with Government to develop green mortgages
- Energy efficiency is not currently a top priority for homebuyers.

Introduction

The Building Societies Association (BSA) represents all 43 UK building societies, as well as five credit unions. Building societies have total assets of £415 billion and, together with their subsidiaries, hold residential mortgages almost £330 billion, 23% of the total outstanding in the UK. They hold over £280 billion of retail deposits, accounting for 19% of all such deposits in the UK. Building societies account for 37% of all cash ISA balances. They employ approximately 42,500 full and part-time staff and operate through approximately 1,470 branches.

Response

The economic opportunity

What economic costs and benefits does decarbonisation present for the UK?

As homes account for 15% of the UK's greenhouse gas emissions the BSA recognises the importance of improving the energy efficiency of the UK's homes.

As mortgage lenders, building societies have a clear interest in good-quality housing, which includes energy efficient properties. Decarbonisation also has the secondary benefit of reducing the likelihood of severe weather events, such as flooding, which can damage homes and potentially affect a lender's mortgage security. However, there is also a danger in moving too quickly and creating consumer detriment for those who could be left behind. The BSA believes that the ambition shown in the Government's targets is about right.

Our key message to the Committee is that there needs to be a balance between achieving high levels of energy efficiency and keeping the costs low for consumers when upgrading their homes. This needs to be a gradual path rather than a 'big bang' and we feel that current targets, though challenging, respect this balance.

To a certain extent energy efficiency improvements will continue to happen 'naturally' with advancements in technology, such as better boilers, solar panels and more efficient building methods, such as Modern Methods of Construction (MMC). The 2019 English Housing Survey found that three quarters of owner-occupiers had installed at least one energy efficiency measure in the last five years, with servicing or replacing a central heating boiler or putting in loft insulation the most common measures.[1]

There have also been advances in reducing fuel poverty, as noted in the Clean Growth Strategy:

> 'In particular, progress has been made to upgrade the homes of those living in fuel poverty: the number of fuel poor households in England living in homes at energy efficiency rating E or below reduced from 1.8 million in 2010 to 920,000 in 2015'[2]

We would like to see Government go further and announce a timetable and the incentives (or consequences) for consumers to improve energy efficiency. As buy-to-let lenders, building societies have to assess the risk of lending to some landlords in the event that they are unable to rent their properties out if they do not meet the required standards. As lenders they can work with landlords to anticipate any change if they are aware of changes in advance. This process becomes more challenging in a shorter timeframe.

What benefits can a growth of the Green Finance sector deliver for the UK, and does the UK hold a competitive advantage in this space?

The Global Green Finance Index currently places London at first place in terms of quality of green finance, and fifth in terms of the depth of the market behind Amsterdam, Zurich, Copenhagen and Luxembourg. It is difficult to say that the UK holds a competitive advantage However having a large financial centre in London, as well as smaller hubs in Birmingham, Manchester and Leeds offers potential. Building societies are all headquartered outside of London.

In terms of green mortgages, only one small UK lender, the Ecology Building Society is taking part in the European Energy Efficient Mortgages Action Plan pilot project. This is in contrast to the involvement of large lenders such as Credit Agricole and Rabobank in France and the Netherlands.

HMT's strategy

How does HMT work with the Clean Growth Strategy and government departments to support decarbonisation? Is this working well?

Treasury officials are in regular contact with BEIS on green finance, and particularly green mortgages. The Treasury addressed the issue of the Green Finance Strategy presented at a building society regional meeting. We believe this relationship works well but will inevitably be driven by BEIS in terms of energy efficiency, and MHCLG on housing policy, such as MMC, which also have an effect on the decarbonisation of the UK's housing stock.

What role should the 2019 Comprehensive Spending Review play in UK decarbonisation? What projects or measures should receive additional funds through this process?

In terms of retrofitting homes it would appear the most important trigger points for incentivising consumers to make changes would be when they move into a home or come to sell a property. This minimises disruption to the homeowner once they have moved into the property.

The Treasury's property taxes are charged at convenient times in the home buying and selling process: stamp duty when people first buy their home and capital gains tax on people selling buy-to-let properties. It would therefore seem sensible for the Treasury to consider how they

[1]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/817757/EHS_2017-18_Energy_Report.pdf
[2]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/700496/clean-growth-strategy-correction-april-2018.pdf

can incentivise energy efficiency improvements through rebates on these taxes. This is something being discussed currently by the Sustainable Energy Authority of Ireland[3]. Ireland is an interesting case study as they already have in place a system of energy efficiency incentive credits on bills where a homeowner can prove they have made energy efficiency improvements[4].

Green finance

What steps have UK banks, asset managers, and pension funds taken to 'green' their business models, investments strategies and balance sheets, taking in to account climate and transition risks?

The majority of the building society sector is at an early stage in understanding how 'green' their mortgage books are. Currently societies ask for confirmation from a landlord that their property meets the Minimum Energy Efficiency Standard (MEES) and manually check the online EPC Register. The Green Finance Strategy commits to making this open data available via an API.

There is a gap in data as consumers are only required to have an energy efficiency assessment when selling or letting their home. Government should explore whether there are any other potential triggers for an assessment.

However, must be taken to not red line properties with lower energy efficiency ratings, as these will tend to be older properties which may be difficult and expensive to retrofit.

Are there any barriers (regulatory or otherwise) preventing financial services firms from delivering green finance or investing in 'green' assets?

There is an assumption that the cost of a mortgage could be a distinguishing factor. In an ultra-low interest rate environment, this may not be a differentiating factor, particularly if retrofitting costs are high.

What prudential risks does climate change pose?

The Bank of England's *Transition in Thinking Paper* breaks the risks from climate change down into credit, operational and market risks[5]. We note that CP23/18 does not adopt these categories, but it is worth noting that building societies for the most part do not engage in corporate financing or proprietary trading. Therefore the BSA sees societies' risks mainly lying within the credit and operational categories. The main market risk that building societies are exposed to is interest rate risk, which may be affected by climate change (if transition to a low carbon economy were to imply a more gradual path of inflation). Another consideration is that larger societies' actions on climate change may feed into their ESG rating should these become more prevalent in the wholesale money markets in future.

To an extent, the BSA believes physical risks will be largely accounted for within current credit risk and lending policies. As the Bank notes in *Transition in Thinking*[6], it is a condition of taking out a mortgage that the borrower have a home insurance policy in place and this largely mitigates against most insurable property risks as things stand today.

[3] https://www.thetimes.co.uk/edition/ireland/huge-investment-needed-to-make-homes-energy-efficient-0h8lrt0q3
[4] https://www.electricireland.ie/residential/help/efficiency/how-do-i-apply-for-the-energy-efficiency-incentive-discount-and-how-will-i-know-when-i-receive-it
[5] https://www.bankofengland.co.uk/prudential-regulation/publication/2018/transition-in-thinking-the-impact-of-climate-change-on-the-uk-banking-sector
[6] https://www.bankofengland.co.uk/prudential-regulation/publication/2018/transition-in-thinking-the-impact-of-climate-change-on-the-uk-banking-sector

Given the long-term nature of a mortgage, which can last for 30-40 years, there is a question whether a property's propensity for flooding decades into the future should feature in lending decisions today. While in our view this is a step too far, lenders could collect this kind of insight as management information to understand how risks could build up in their mortgage book over the long-term.

In terms of lending policies and risk appetites, some societies may choose not to lend in flood plains or certain coastal areas. Yet, it is likely that a more data-driven approach will improve the accuracy of such lending decisions as technology emerges. There are existing datasets on flooding, subsidence, rising sea levels and other environmental factors held by insurers and public agencies. The challenge for building societies will be to develop this knowledge internally so that they can keep oversight of any risks building up in the mortgage book. The BSA is aware that some of our larger members already have projects in place to do so but smaller societies may need more support through the Climate Financial Risks Forum, for example.

Transition risks are subject to a greater degree of uncertainty than physical risks and depend largely on government actions to move towards a low-carbon economy. Much depends on the extent of change planned and over what timeframe. The BSA and our members are supportive of measures to improve energy efficiency and combat climate change but it may be difficult for firms to assess and mitigate any transition risks until concrete policies with timetables are announced, so that these risks can then be quantified and planned for.

The Government's aim for as many private-rented homes as possible to have a C rating or above by 2030, as expressed in the Clean Growth Strategy, will be challenging – given that around 72% of the UK's homes have an EPC rating below C. The aim in the Clean Growth Strategy for *as many homes as possible* to be EPC Band C by 2035 extends this risk beyond lenders' buy-to-let books, though it is unclear whether the Government intends to introduce fines for non-compliance in the owner-occupied sector. We note that the Green Finance Strategy suggests setting requirements for lenders to help households improve the energy performance of homes they lend to. While this may be challenging to implement, we will work with BEIS to develop the policy proposals.

Of course, as lenders exposed to the housing market and the economy more generally, the main transition risk for building societies lies in whether the UK can transition to a low-carbon economy in an orderly manner. The BSA has had some involvement in projects, such as LENDERS, which produced a report on green mortgages in the UK, and has an ongoing work strand looking at MMC which could produce more energy efficient housing stock in the future.

Regulators could provide incentives for lending on energy efficient homes, either through the capital framework, or via the FPC's housing tools. We note that the FPC discussed the 2021 biennial exploratory scenario exploring resilience to the financial risks of climate change in the July 2019 Financial Stability Report[7]. In Europe, the Commission and Parliament are considering a 'green supporting factor' which would mean lenders commit less capital to loans that contribute towards the transition to a carbon-neutral economy and this is supported by the European Banking Federation[8].

What is the Financial Conduct Authority and the Prudential Regulation Authority doing to support decarbonisation and a 'greening' of the financial system?

As a forward-looking regulator, we recognise that the PRA has a role to play in minimising the potential risks that climate change poses to financial stability. We would also urge the Government to continue learning from other jurisdictions such as the Netherlands, which has a particularly advanced approach to combatting the risks from climate change. For example, the Dutch Central Bank announced its intentions to imbed climate-related risks in their

[7] https://www.bankofengland.co.uk/financial-stability-report/2019/july-2019

[8] https://www.ebf.eu/regulation-supervision/green-finance-green-supporting-factor-is-a-sensible-idea/

supervisory approach in 2017 and large banks know the EPC rating of about 50% of their mortgages. UK banks and building societies still have some way to go towards collecting and integrating this data.

It is clear that improving the way the financial industry plans for climate change will involve cooperation among a wide range of firms and stakeholders on non- competitive issues. The BSA welcomes the PRA's commitment to work with the FCA and other stakeholders on establishing the Climate Financial Risk Forum. The Forum should publicly work with as wide a range of firms as possible, otherwise there is a risk that some will fall behind in their ability to comply with the PRA's expectations.

What expectations do (and should) they place on regulated firms about their role in the transition through their policy and supervisory activities?

PRA regulated firms are required to have a nominated senior manager responsible for identifying and managing the financial risks from climate change by 15 October. Firms are required to have clear roles and responsibilities for the board and its relevant sub-committees in the context of the firm's overall business strategy and risk appetite.

It is important to highlight that the PRA expects a firm's response to the financial risks from climate change to be proportionate to the nature, scale and complexity of its business. As outlined above, we believe the main risks for building societies sit within the mortgage book. However, smaller firms will not have the same level of resource and expertise to carry out a full risk assessment on day one and will need to develop their approach over time as they get access to data and develop understanding. Indeed, the PRA's requirement is for firms to have an initial plan in place to address their supervisory expectations with an understanding that these will mature as the expectations become clearer.

What is the consumer demand for 'green' financial products?

According to the 2017-18 English Housing Survey, less than a fifth of owner occupiers stated that the EPC rating influenced the choice to buy their home. This underlines that energy efficiency is only one of a number of factors and currently ranks lower in priority than factors such as location or transport links. Therefore, green mortgages, which base discounted rates on energy performance, would tend to appeal more to consumers who already value energy efficiency more highly, and this is supported by the finding in the Survey that homeowners in EPC A or B rated homes more often recalled having seen the certificate in the home buying process[9]. This indicates that there is scope for a consumer awareness and education programme.

Are there a range of accessible options available to consumers seeking to source 'green' financial products across the product suite (for example, mortgages, bonds, investment products, savings accounts, loans)? Do certain instruments dominate the green finance landscape, and if so, why?

The green mortgages market is at an early stage in its development. Currently two building societies offer variations on green mortgages. Ecology Building Society has been providing green mortgages for nearly 40 years and offers a range of discounts designed to incentivise energy efficiency by basing their mortgage rates on a property's energy rating. For renovations or conversions, particularly whole house retrofit, Ecology offers a stepped discount for every EPC rating improvement achieved - the greater the improvement, the greater the discount. For Ecology also offer stepped discounts for energy-efficient new builds, particularly self or custom build projects, from a B EPC rating up to Passivhaus standards. The discount is applied from the Standard Variable Rate once the borrower provides proof of the

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[9]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/817757/EHS_2017-18_Energy_Report.pdf

improved or energy rating achieved.Ecology also has'energy improvements mortgage' which can be used to fund specific measures such as insulation, double or triple glazing, efficient heating systems, solar panels, photovoltaics, wind turbines, ground source heat pumps and biomass heating.

Similarly, Melton Mowbray Building Society offers an ECO mortgage on self-build, renovations or conversions where an EPC rating of A or B is expected to be achieved and where at least one renewable energy feature has been designed into the build.

The BSA is also working with BEIS to look at the requirements for lenders to help households improve the energy performance of homes they lend to, as proposed in the Green Finance Strategy, and the wider market for green mortgages.

By Charlie Blagbrough & Kate Creagh
Mortgage Policy Manager & Public Affairs Manager
Kate.Creagh@bsa.org.uk
020 7520 5905

York House
23 Kingsway
London WC2B 6UJ

020 7520 5900
@BSABuildingSocs
www.bsa.org.uk

BSA EU Transparency Register No: 924933110421-64

www.bsa.org.uk

The Building Societies Association (BSA) is the voice of the UK's building societies and also represents a number of credit unions.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the Government and Parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £400 billion, and account for 23% of the UK mortgage market and 19% of the UK savings market.