Green loans

Green lending is currently under-used in the property sector, but could it be a win-win for real estate developers and banks alike?

Patrick Keown examines the key features of green finance and looks at its potential benefits for property developers

It is undeniable that banks can have a central role to play in the development of green infrastructure. While green bonds have been a go-to for those interested in raising capital and investing in environmentally-friendly projects, green lending remains under-developed and under-used as a way of encouraging green real estate, particularly in the UK. And yet, green lending could be the answer to the UK's current housing shortage, while helping to consolidate the country's position as an international hub of green finance. So what exactly is green finance, and what are the advantages of green loans for banks and property developers alike?

What is green lending?

While no dictionary definition of green lending exists, it is generally understood to mean lending that is dependent on meeting environmental criteria through the use of funds.

In March 2016, Lloyds Bank (Lloyds) stole the spotlight when it pledged £1bn in loans for green buildings in the framework of its Commercial Real Estate Green Lending Initiative. Under the scheme, borrowers can benefit from a margin discount of up to 20 basis points (equivalent to a 0.2% decrease in payable interest) for loans of over £10 million, in return for meeting specific sustainability covenants for the duration of the loan.

In October 2016, Lloyds agreed to loan HPH Commercial Property £14m to invest in improving the efficiency of the properties in its portfolio; while HFP Property group secured £39.7m under the scheme to build what will be one of the UK's greenest university campuses for the University of West Scotland.

Individuals are already able to take advantage of some green loans in the form of so-called 'green mortgages'. The Ecology Building Society, for example, provides mortgages on projects that are built or renovated with environmental factors taken into consideration. This includes a 1% discount on the mortgage rate for an existing home, and a 0.5% to 1.25% discount for new builds.

Barring Lloyds' Green Lending Initiative, however, the availability of green loans for property developers remains surprisingly scarce. This is particularly true in the small-mid-level property development market. And yet, energy efficient property investments could be the answer both for developers seeking to access capital and for banks seeking returns on their investments, while being anxious to limit their lending for speculative projects.

Green loans: lower risk profiling?

Commitment to the environment and to reducing CO2 emissions is a driving force behind green finance, but it is not the only reason why an increase in green lending could bode well for everyone in the property market. A key advantage of green lending is that it allows banks to gain better insight into the credit worthiness of clients through a closer examination of their underlying assets.

In September 2016, the European Efficient Mortgages Initiative was launched, bringing together, among others, the European Mortgage Federation's European Covered Bond Council, the Royal Institution of Chartered Surveyors, as well as the energy provider EON. One of the aims of the project is to explore the link between energy efficiency, a borrower's reduced probability of default, and the increase in value of energy-efficient properties.

If the link between the three is proven, green loans could represent a lower risk than usual real estate loans, allowing them to qualify for better capital treatment. It would also allow for banks to risk profile 'energy efficient' assets and help the market price the added value of green real estate.

If green property development results in safer loans and higher value properties, this could be reflected in the capital requirements set by the Basel Committee, as well as EU and national level financial regulators. Indeed, financial regulators play a central role in encouraging the development of certain key industries. In the UK, for example, preferential risk weighting...
has been used to support SMEs; the same could be done for green property development. A lower risk weight for green property loans would mean reduced capital requirements for banks making these loans – something that is especially attractive for smaller banks which are particularly burdened by the high level of capital they must set aside for more speculative loans, including those for residential developments. This would incentivise banks to make green loans, while ensuring that sufficient capital is available for developers interested in creating green developments.

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Where to go from here?
Environment consultancy Trucost created the tool to assess the initial eligibility of candidates for Lloyds’ green loan. It also identified the appropriate energy and carbon savings targets that borrowers had to meet to receive a discount under the scheme. However, one of the main challenges to green lending in real estate is precisely the lack of standardised benchmarks against which to assess developments and properties and the lack of monetisation of green real estate. Until this is developed, financial regulators and banks alike will be limited in their ability to support green development.

With this in mind, a good place to start would be in the development of basic principles on which to base green lending, in the same way that principles were developed for Green Bonds by the International Capital Market Association with the support of issuers, intermediaries and investors in the Green Bond market. The Loan Market Association – which has recently advocated for the development of green loans – and platforms such as the Better Building Partnership, with its Working Group on Commercial Real Estate Lending, are two avenues through which green lending can be further developed.

Further collaboration between the real estate and banking industries is also essential to allow both sides to take advantage of the opportunities provided by green lending, all the while helping to curb the emissions of an industry that is responsible for nearly half of the country’s CO2 emissions.

Find out more
If you are interested in learning more about what green properties can mean for you, or you represent a bank interested in providing green loans, please contact our Real Estate or Corporate Banking Departments for more information.