

# Regulatory nudge proposed to unlock green retrofit finance for low-income mortgagors

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*UTS Institute for Sustainable Futures has proposed a regulatory nudge to unlock the financing of green retrofits for low-income earners at the most cost-effective interest rate, housing loan interest rates, in a way that is consistent with Australia's strong prudential regulatory framework.*

With energy prices spiking, if a household is not able to make energy efficiency investments to their homes that help to reduce their energy bills, there is a danger that households would be exposed to a “**net zero poverty premium**.” Poverty premiums refer to the cost of being poor.

Affordable, accessible credit that enables households to sustainably retrofit homes can support the transition to net zero emissions in a way that reduces household costs of living and is consistent with credit risk management frameworks. Affordable, accessible credit also supports a just transition.

ISF's report, ***Scaling Green Retrofit Housing Finance*** argues that for Australia's financial system to be able to offer households the opportunity to finance green retrofits at the most cost-effective interest rate, housing loan interest rates, there is a need for Australia's financial system regulatory architecture to support innovation in a way that is consistent with Australia's strong prudential regulatory framework.

Recognising the role that regulation plays in supporting the financial stability of Australia's financial system, ISF's research considers the potential for regulatory nudges. If it can be demonstrated that green retrofits have the potential to improve residential credit risk by reducing customer energy bills, this would provide an evidence base for Australia's prudential regulatory (APRA) to issue guidance to banks on the ways in which finance can be provided to customers with existing housing loan for the purposes of green retrofits.

To provide APRA with confidence to issue ***Green Retrofit Housing Loan Prudential Guidance*** that would enable banks to increase existing housing loans under agreed conditions ISF proposes that APRA build a ***Green Retrofit Finance Housing Model*** to test the impact of loan extensions and deferrals on credit risk.

Models are commonly used by Australia's financial system to support financial decision making. A Green Retrofit Finance Housing Model would use de-identified banking customer data and published energy savings data to model potential customer bill savings and impacts on consumer credit risk. Modelling allows for the impact of retrofit financing mechanisms on credit risk to be isolated from other influences. The rationale for APRA to build a model is that they already have access to bank data on housing loans.

ISF proposes that APRA identify a cohort from the lowest loan repayment quartile that have low loan to valuation ratios, high liquidity buffers and mortgage payments that are not in arrears that would be eligible for a pilot. These three factors combine to identify low risk customers from a bank perspective. Low-income mortgagors are of mortgagor incomes. There are 766,220 loans identified by the Reserve Bank of Australia as the lowest loan repayment quartile group.

Key research insights from ISF's report:

1. The structure of lending influences household decisions.
2. Green retrofits can reduce household costs.
3. Green retrofits should improve credit risk for banks.
4. Scaling green retrofits requires regulatory support for banks to innovate.

## Structure of lending influences household decisions

A significant impediment to households accessing finance for green retrofits is the way lending products are structured. The form of credit influences the cost of credit. **Residential housing loans and residential investment loans are the most cost-effective sources of financing** as loans are secured against the housing asset. The rate of interest ultimately has an impact on demand for credit. If customers are not able to access the lowest available interest rates, then there will be less demand for green retrofits.

The challenge for households is that when a housing loan is approved by a bank to purchase, or refinance, an existing house, **the need for the householder to make future green retrofits is not included as part of the loan contract**. If customers are required to reapply for their loan to access finance this acts as a significant disincentive and pushes customers towards products that have shorter terms for repayment or higher interest costs. This has the potential to deter households from making decisions to invest in a green retrofit.

## Green retrofits can reduce household costs

**There is a range of evidence that suggests that green retrofits can reduce household costs** over the lifetime of the retrofit:

- In Victoria, where more than half of all energy used in homes comes from piped gas, the Victorian Government's own estimates are that switching from gas to efficient electric appliances could reduce average household energy bills by around \$1,250 per year.
- Research by the Institute for Sustainable Futures has found that domestic hot water use is responsible for around a fifth of Australian residential greenhouse gas emissions and a quarter of household energy use. The phasing out of gas water heaters in homes would provide consumers with combined annual savings of \$4.7–6.7 billion by 2040.
- Climate Council analysis reveals that electrifying a home's cooking, heating and hot water combined with practical efficiency upgrades would save between \$1,119 and \$2,872 each year and also reduce greenhouse gas emissions by an average of 37.5 tonnes over a decade.
- Climate Works Renovation Pathway Project has identified that across the various housing types most common for Australia, households could expect to see energy consumption savings in the range of 55–65% on average from thermal shell improvements and efficient and electrified appliances.

## Green retrofits may improve credit risk for banks

Integrating green retrofits into residential lending practices has the potential to improve credit risk for a bank portfolio in two ways. **A reduction in energy bills for households improves a bank's serviceability ratios**, whilst the increased value of a house as a result of the retrofit improves an

bank's loan to valuation ratios. Further, banks are being driven to decarbonise their residential lending portfolios to meet their net zero commitments - scaling retrofits is an essential component.

## **Scaling green retrofits requires regulatory support for banks to innovate**

Our research has considered the role that Australia's financial regulatory system can play in supporting housing loan customers to efficiently and cost effectively access finance for the purposes of investing in green retrofits. A key question the research examines is how the Australian Prudential Regulation Authority (APRA) can support banks to provide their customers with access to finance at the most cost-effective rate of interest, which is the rate of interest on housing loan products.

Initiatives that have focused on green retrofits for vulnerable households have commonly focused on grant based or incentive mechanisms. A key challenge our research seeks to address is how finance can be made more broadly accessible for low-income households for the purposes of investing in green retrofits. This would provide an alternative to grant-based schemes in fiscally challenging circumstances and would support a just transition.

## **Green Retrofit Housing Loans would benefit from regulatory guidance**

Increasing a customer's housing loan to allow investment in a green retrofit is perhaps the most logical pathway for customers to access finance. The challenge with this pathway is that, under existing regulatory arrangements, a customer would need to reapply for the home loan. The time and cost of reapplying for a loan act as a significant disincentive.

Investing in green retrofits has the capacity to support a household to reduce energy costs, thereby improving the ability of a household to service housing loan commitments, decreasing credit risk and also climate-related financial risk. A bank's serviceability assessment, which is based on the Household Expenditure Measure (HEM), can demonstrate that a green retrofit improves the capacity of a customer to service a loan in the long term. Loan to valuation ratios are also improved if data can demonstrate the impact of a green retrofit on the value of a house.

We argue that there is a need for regulatory guidance that allows banks to either increase the amount of a housing loan or pause mortgage repayments to invest in a green retrofit. A customer that pauses mortgage repayments to invest, with the approval of their bank, in a green retrofit should not be considered in the same way as a loan that is in arrears for other reasons.

If green retrofits improve a bank's credit risk, then this could justify the issuance by APRA of guidance to support the scaling of finance.

## **Conclusion**

We are currently seeing innovations around financing of green retrofits. This includes banks that are developing innovative products as well as new innovative platforms. The Australian Government's recent announcement to align NatHERS with banking lending processes and provide \$1 billion to the Household Energy Upgrades Fund to help provide low-cost loans for double-glazing, solar panels and other improvements will support further innovation.

We have however yet to see innovations that are targeting the 766,220 loans that are in the lowest loan repayment quartile group of housing loans. With energy prices spiking, if a household is not able to make energy efficiency investments to their homes that help to reduce their energy bills, there is a danger that households would be exposed to what we describe as a "net zero poverty premium."