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A guide to green mortgages

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Green mortgages

Shepherd and Wedderburn has committed to achieving net zero greenhouse gas emissions by 2030. We work with organisations active in all sectors of the economy to deliver a green recovery that has sustainability and resilience at its heart.

We are a leading UK law firm delivering comprehensive, multi-jurisdictional legal advice across every business sector, as well as offering the full range of private client and wealth management services.

Our firm has well-established experience in the financial sector, having been at the forefront of innovative developments and involved in many significant transactions and cases. Our broader financial sector team is an integrated group of more than 30 lawyers with extensive knowledge of the sector and experience working across the different divisions in the firm.

This guide provides an introduction to green mortgages, covering the following four aspects:

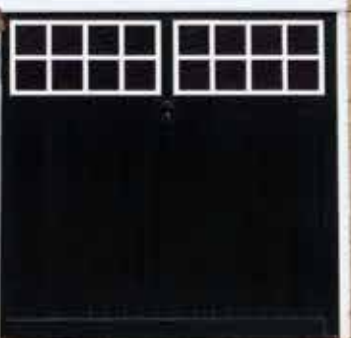
- **What are green mortgages:** [Section 1](#) looks at how green mortgages differ from conventional mortgage loans, why they are attractive to homeowners and lenders, and how political developments at a national and global level are driving innovation in green mortgages.
- **How are green mortgages regulated:** [Section 2](#) examines what support is already in place for green mortgages under the

current regulatory regime and what opportunities there are for the government to introduce further regulatory support in order to encourage growth in the green mortgage market.

- **How are green mortgages documented:** [Section 3](#) explains the customer-facing documentation that is used by mortgage lenders to originate – or write – new green mortgages, including practical tips for developing good legal documentation for green mortgages.
- **How are green mortgages funded:** [Section 4](#) considers the financing structures that are used by mortgage lenders in order to fund green mortgages, drawing on the latest developments in the UK capital markets.

“They are commercial, pragmatic, responsive and really know their field inside and out”

– Chambers 2021



Section 1

What are green mortgages?

The first green mortgages in the UK were launched in 2006 by a specialist building society established to help finance environmental building renovations and support sustainable development. For a long time, it was the UK's only green mortgage lender and, until recently, green mortgages were a niche form of home finance.

However, in the last couple of years, green mortgages have started to enter the mainstream as major high-street lenders begin to launch their green mortgage offerings. There are now more than a dozen large brands offering green mortgage products.

There is no universal definition of what a green mortgage is, but there are common features across the green mortgage products currently available in the UK. Most green mortgage products can be divided into one of two categories:

- **Building or buying an energy efficient home**

The first type of product is a mortgage that offers customers a discounted rate of interest when building or buying an energy efficient home, for example, where the borrower benefits from a fixed reduction on the lender's standard

interest rates for the life of the mortgage.

A variant on this type of product is where the financial incentive for the borrower takes the form of cashback payable by the lender upon completion of the mortgage, rather than a discounted mortgage rate. The cashback may be released by the lender through the solicitor or conveyancer acting on the mortgage or paid directly to the customer.

New build properties will often be required to have a minimum Energy Performance Certificate (EPC) rating of "A" or "B" in order to qualify for a green mortgage. Typically, the mortgage lender will expect a copy of the EPC to be submitted by the borrower with their mortgage application.

For properties in the course of construction, the energy

efficiency rating may be based on a Predicted Energy Assessment (PEA) certificate.

- **Improving the energy efficiency of an existing home**

The second type of green mortgage product is a secured homeowner loan to finance improvements to the energy efficiency of an existing building. The borrower will typically have to spend at least half of the amount borrowed on specific energy efficiency improvements or on upgrades that increase the property's EPC rating to a specified level. The works may have to be carried out by an accredited or registered supplier.

When the borrower provides proof that the energy efficiency improvements have been made to the property, they will usually either qualify for a cashback payment from the lender or benefit from a discount on their mortgage rate. The discounted mortgage rate will typically only apply for a fixed period after which the lender's reversionary rate will apply, rather than the interest rate being discounted for the full term of the mortgage.

What makes green mortgages different from other conventional mortgage loans?

The key difference with a green mortgage is the link between the cost of borrowing and the energy efficiency of the mortgaged property.

From the borrower's perspective, the financial incentive is clear. Their monthly payments on a green mortgage will be lower – or they may receive a cashback payment on completion of the mortgage (if it is a new build) or on completion of any retrofitting works (if it is an existing building).

From the perspective of the mortgage lender, one reason why green mortgages can be attractive is that the energy efficiency of a property can predict the likelihood of a borrower defaulting on their mortgage.

There are many other factors that influence the likelihood of mortgage default, including income, age, geography and property value. However, there is now a growing body of research, including publications from the Bank of England¹, which indicates that mortgages against energy-efficient properties are less frequently in payment arrears than mortgages against energy-inefficient properties.

In the UK, a significant proportion of our housing stock will need energy efficiency improvements over the coming years in order to continue to be fit for purpose. The UK Committee on Climate

Change has estimated that £250 billion needs to be invested in home upgrades by 2050.²

Green mortgage products that offer finance to retrofit existing buildings are ideally suited to help support the greening of the UK housing stock, because they provide a financial incentive for homeowners to undertake energy improvement work.

The market for financial services is evolving and UK consumers are becoming more discerning in their choice of financial services providers. Borrowers are increasingly demanding that lenders act in a way that is purposeful and socially responsible.

Many investors are now employing environmental, social and governance (ESG) criteria



to assess organisations and investments. ESG criteria are a loose set of standards for benchmarking an organisation's operations. Environmental criteria consider how an organisation performs as a steward of nature. Social criteria examine how it manages relationships with employees, suppliers, customers, and the communities in which it operates. Finally, governance deals with an organisation's leadership, executive pay, audits, internal controls and shareholder rights.

Green mortgages are well aligned with ESG factors, given their environmental and social outcomes in terms of improving the energy efficiency of homes.

It is likely that ESG benchmarking will become more prevalent in the mortgage industry in the near future. The Department for Business, Energy and Industrial Strategy (BEIS) ran a public

Green mortgages are well aligned with ESG factors, given their environmental and social outcomes in terms of improving the energy efficiency of homes.

consultation from November 2020 to February 2021 on setting requirements for lenders to help householders improve the energy performance of their homes.³

Among the proposals under consultation is a regime which would require mortgage lenders to disclose the energy performance of their loan books. In other words, annual reporting of average EPC ratings by mortgage lenders, with year-on-year comparisons.

The disclosure regime could effectively act as an ESG league

table generating competition between mortgage lenders and leading to portfolio-wide improvements.

It could provide the impetus for lenders to develop innovative products that encourage householders to improve the energy performance of their homes. This could reduce the risk of certain homes becoming "stranded assets" as energy performance standards are tightened. Stranded assets are assets that suffer from an unanticipated or premature drop in value caused by environment-related risks.

While the disclosure regime could have very positive outcomes for the green mortgage market if it is introduced, there is also a risk that the regime could create a new generation of "mortgage prisoners", if energy-inefficient properties become unattractive to mortgage lenders.

¹ Bank of England, "[Does energy efficiency predict mortgage performance?](#)" (Staff Working Paper No. 852), January 2020.

² Committee on Climate Change, [The Sixth Carbon Budget](#), December 2020.

³ Department for Business, Energy & Industrial Strategy, [Improving home energy performance through lenders](#), November 2020.

Recent and current policy initiatives

Recent and current policy initiatives at a national level have influenced the evolution of the UK green mortgage market.

Going back a decade, the [Energy Act 2011](#) saw the UK Government launch a flagship initiative to improve the energy performance of buildings by removing the up-front cost of energy efficiency measures. The initiative was called the “Green Deal” and was based on a key principle that energy efficiency improvements to properties should pay for themselves through the resulting savings on energy bills.

The Green Deal was a “pay-as-you-save” arrangement where loans were made to householders to cover the cost of energy efficiency measures and the loan repayments were recovered through the householder’s electricity bill. It had limited take-up and was effectively closed to new applications from 2015.

The successor to the Green Deal was the Green Homes Grant, launched in September 2020. The Green Homes Grant

scheme allowed homeowners to apply for vouchers towards the cost of making energy efficient improvements to their property. The scheme was beset with administrative problems and delays, and was scrapped in March 2021.

While neither the Green Deal nor the Green Homes Grant really took off, both initiatives acknowledge the importance with which government policy-makers view the task of making our buildings more energy efficient.

That importance was further emphasised in the UK Government’s [Ten Point Plan for a Green Industrial Revolution](#), published in November 2020, with a focus on catalysing a green recovery following the economic impact of the coronavirus pandemic. Point 7 of the plan is entitled “Greener Buildings”. It outlines funding and regulatory

measures, to be delivered in partnership with industry, in order to ensure that new buildings are future-proofed with high levels of energy efficiency.

Hot on the heels of the Ten Point Plan for a Green Industrial Revolution came the UK Government’s [Energy White Paper](#) in December 2020. The White Paper sets an ambition of improving the EPC rating of some 27 million existing homes to band C by 2035, where it is practical, cost-effective and affordable to do so.

Achieving that ambition is an enormous challenge, but it is clear that there is a need – and an opportunity – for significant capital to be deployed by financial institutions to support householders in retrofitting their homes.

A number of financial sector initiatives are already underway to help accelerate green finance. The International Capital Market Association (ICMA), a trade body for participants in the capital



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markets, has developed the [Green Bond Principles](#) to promote the development and integrity of green bond instruments. The Green Bond Principles are a framework of market standards and voluntary guidelines that issuers and investors in the debt capital market are encouraged to adopt for green bonds.

Building on the success of the Green Bond Principles, the Loan Market Association (LMA), which represents banks and borrowers

in the syndicated loan market, has remodelled the framework as the [Green Loan Principles](#) for use by lenders and borrowers of green loans in the corporate space.

In September 2020, a specific framework of market standards and voluntary guidelines for green mortgages, called the [Green Home Finance Principles](#), was released by the Green Finance Institute. The Green Home Finance Principles, are intended to provide a consistent and transparent methodology for mortgage lenders to allocate finance towards retrofitting works in the UK's domestic buildings.



Green mortgages in the wider context

In December 2015, the [Paris Agreement](#) was adopted by nearly 200 states at the United Nations Climate Change Conference. The agreement is a binding international treaty to limit global warming in order to avoid the most dangerous effects of climate change.

Just a couple of months before the Paris climate accord, the general assembly of the United Nations established a set of 17 [Sustainable Development Goals](#) (SDGs) to act as a blueprint for achieving a better and more sustainable future for all people and the world by 2030.

In line with its commitments under the Paris climate accord, and also demonstrating its implementation of the UN SDG's, the UK became the first major economy to pass laws committing to achieving net zero greenhouse gas emissions by 2050.⁴ The Scottish Government at Holyrood then upped the ante by delivering landmark legislation to commit

Scotland to becoming a net-zero society by 2045, five years before the rest of the UK.⁵

Given that 15% of the UK's total climate emissions come from residential property – 5% more than agriculture, and only 2% less than business, based on government statistics⁶ – it is clear that fundamental changes to the energy performance of our built environment are required in order to achieve the goal hitting net zero by 2050 – or 2045 for Scotland.

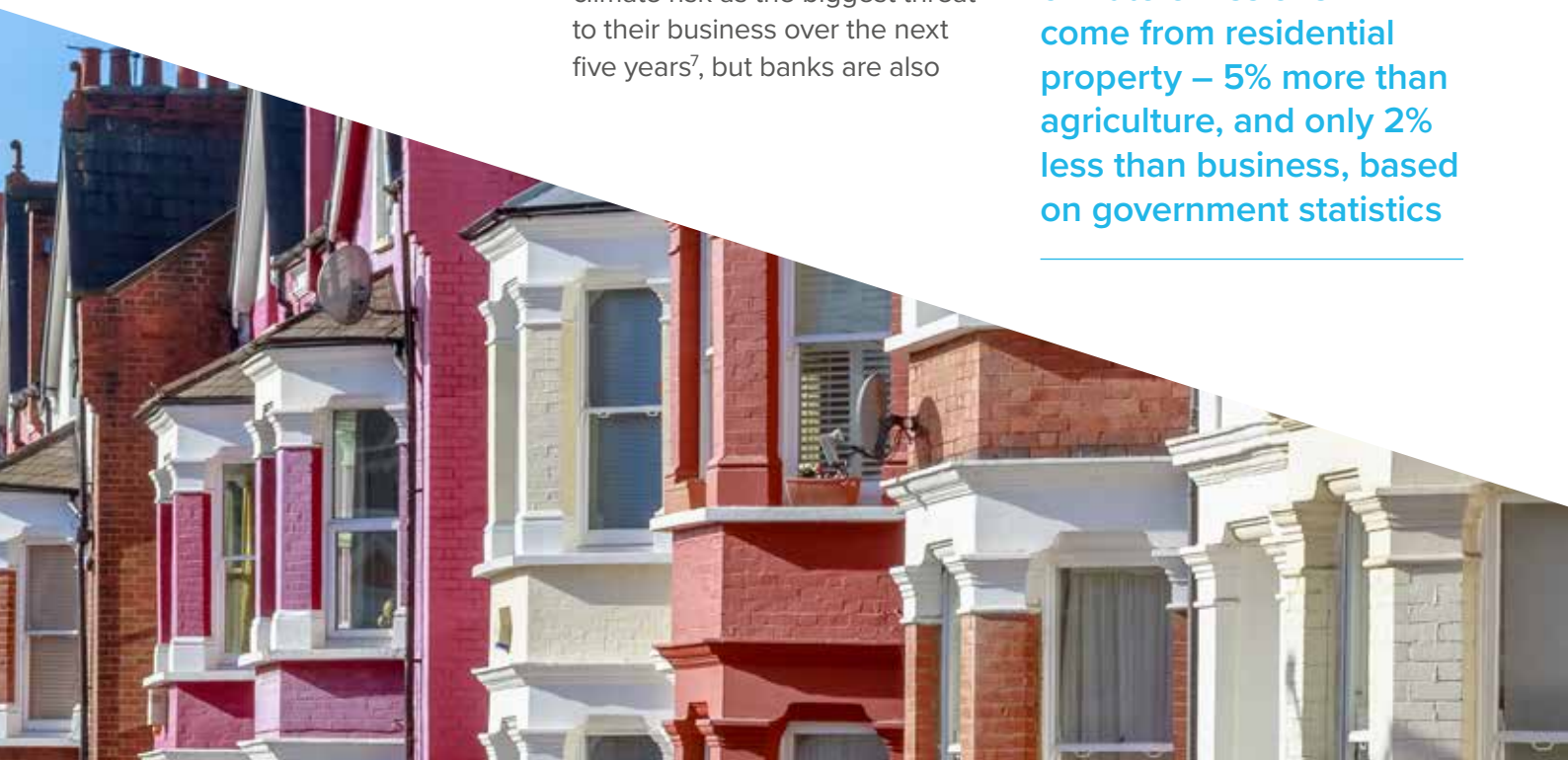
A recent poll by accountancy firm EY and the Institute of International Finance (IIF) found that bank risk managers view climate risk as the biggest threat to their business over the next five years⁷, but banks are also

looking at climate risk as an opportunity. There is a realisation in the financial services industry that we cannot get to a zero-carbon economy without finance. The need for financial solutions such as green mortgages is only going to increase in the coming years.

As well as the Paris climate accord and the establishment of the UN SDGs, there are other international developments influencing how financial institutions behave in relation to climate change.

A [Task Force on Climate-related Financial Disclosures](#) (TCFD) – was created in December 2015 by the Financial Stability Board, which monitors the global financial system. Since its launch,

15% of the UK's total climate emissions come from residential property – 5% more than agriculture, and only 2% less than business, based on government statistics



the TCFD has been instrumental in advancing the availability and quality of reporting by companies of climate-related financial information. Financial markets need data on the impacts of climate change in order to assess the risks and opportunities presented by rising temperatures, climate-related policy, and emerging technologies.

Improved and increased reporting by companies of climate-related financial information will help redirect global financial capital away from businesses that are overly exposed to fossil fuels and towards firms with an environmentally sustainable business model. Mortgage lenders with green credentials stand to benefit from greater transparency on climate-related financial information.

The SEC Centre in Glasgow, where the 2021 United Nations Climate Change Conference (COP26) was held, witnessed 13 days of intense international negotiations, culminating in the [Glasgow Climate Pact](#), which takes forward the goal under the earlier Paris Climate Agreement of limiting global warming to 1.5°C

“ When you look at climate change from a human mortality perspective, it will be the equivalent of a coronavirus crisis every year from the middle of this century, and every year, not just a one-off event. So it is an issue that needs to be addressed now.”

– Mark Carney, United Nations Special Envoy for Climate Action and Finance

above pre-industrial levels by 2050.

Just before COP26 kicked off, in October 2021, the UK Government published its [Green Finance Roadmap](#), detailing forthcoming initiatives such as the Sustainability Disclosure Requirements (SDR), which will focus on harmonising the disclosure of sustainability-related information by financial market participants and financial advisers.

SDR is part of a broader package that aims to improve transparency and stamp out so-called “greenwashing”, a term describing unsubstantiated claims about the environmentally-friendly nature of a product. Greenwashing is viewed as a particular mischief because a lack of confidence in the integrity of

green financial products could stymie further growth in green finance.

The UK Green Taxonomy is another part of the Green Finance Roadmap. Mirroring the EU Taxonomy Regulation⁸, it will set out a classification system – known as a “taxonomy” – for investors and businesses to assess whether economic activities are “sustainable”. In essence, it is a catalogue of what activities may and may not be described as sustainable.

All of these political developments form the backdrop to today’s green mortgage landscape and help to explain why, after more than a decade on the fringes of the UK home finance market, green mortgages are suddenly taking off.

⁴ [Climate Change Act 2008 \(2050 Target Amendment\) Order 2019](#).

⁵ [Climate Change \(Emissions Reduction Targets\) \(Scotland\) Act 2019](#).

⁶ [2019 UK Greenhouse Gas Emissions, Final Figures](#).

⁷ 11th annual EY / IIF global bank risk management survey, “[Resilient banking: capturing opportunities and managing risks over the long term](#)”, June 2021.

⁸ [Regulation \(EU\) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation \(EU\) 2019/2088](#).



Section 2

How are green mortgages regulated?

At the core of the scheme of financial services regulation in UK is the “general prohibition” contained in section 19 of the [Financial Services and Markets Act 2000 \(FSMA\)](#). The general prohibition provides that no person may carry on a regulated activity in the UK, or purport to do so, unless they are an authorised person or an exempt person.

An authorised person is someone who has been given permission by the Prudential Regulation Authority (PRA) or the Financial Conduct Authority (FCA) to carry on a regulated activity.

It is important to note that the regime for regulating financial services in the UK is activity-based. It is the act of carrying on a financial services activity by way of business which is regulated.

The financial services activities that constitute regulated activities for the purposes of FSMA are defined by a statutory instrument called the [Financial Services and Markets Act 2000 \(Regulated Activities\) Order 2001](#) – generally just known as the Regulated Activities Order (RAO).

There are two main activities in relation to green mortgages which fall within the scope of regulation under FSMA. Both activities are set out in [article 61](#) of the RAO:

- **Entering into a regulated mortgage contract as lender**

The first is the activity of entering into a regulated mortgage contract as lender. In other words, originating a regulated mortgage contract.

- **Administering a regulated mortgage contract**

The second is the activity of administering a regulated mortgage contract.

Administering a regulated mortgage contract, in essence, means servicing the mortgage.

In particular, it covers issuing any notifications to the borrower under a mortgage contract, for example, changes in interest rates or payments due under the mortgage. It also includes taking any necessary steps to collect or recover payments due from the borrower under the mortgage contract.

In addition to those two main regulated activities of originating and servicing, there are further regulated activities covering arranging regulated mortgage contracts⁹ and advising on regulated mortgage contracts¹⁰, which also apply in the case of green mortgages.

This means that mortgage intermediaries, such as brokers, who arrange mortgages for borrowers – whether those are green mortgages or conventional mortgages – need to be authorised under FSMA.

In the same way, anyone providing a borrower with advice on the merits of taking out either a green or conventional mortgage will require authorisation under FSMA – whether that is the mortgage lender itself (in the case of a direct advised sale)

⁹ [Financial Services and Markets Act 2000 \(Regulated Activities\) Order 2001, article 25A.](#)

¹⁰ [Financial Services and Markets Act 2000 \(Regulated Activities\) Order 2001, article 53A.](#)

or a mortgage broker (where the lender uses a network of intermediaries to distribute its mortgages).

The responsibility for supervising financial services activities in the UK is split between two regulators.

- Banks, insurers and major investment firms are supervised by the PRA, which is responsible for ensuring the safety and soundness of those institutions

in order to avoid any adverse effect on the stability of the UK financial system.

- Responsibility for regulating conduct standards in retail and wholesale financial markets sits with the FCA.

Permission to carry on the regulated activities relating to mortgages, including green mortgages, falls within the remit of the FCA, so any firm that wants to enter into a regulated

mortgage contract as lender or administer, arrange or advise on a regulated mortgage contract needs to apply to the FCA for permission to carry on those regulated activities.

Carrying on a regulated activity in breach of the general prohibition is a criminal offence punishable by imprisonment or a fine, or both.¹¹ Any mortgage loan made in those circumstances could also be unrecoverable by the lender.¹²

What is a regulated mortgage contract?

A regulated mortgage contract is an agreement under which a lender provides credit to an individual (or to trustees) where the obligation to repay is secured by a mortgage on land.

The definition of a regulated mortgage contract covers both green and conventional mortgages. The fact that the cost of borrowing under a green mortgage is linked to the energy efficiency of the mortgaged property does not have a bearing on whether

or not it constitutes a regulated mortgage contract.

However, a mortgage will only be a regulated mortgage contract if at least 40% of the mortgaged property is used for residential purposes. For example, a loan secured over farmland would generally not be a regulated mortgage contract, even if there was a farmhouse on that land, unless the farmhouse and associated garden ground make up at least 40% of the total land area of the mortgaged property.

The definition of a regulated mortgage contract in article 61 of the RAO includes both first and second charge mortgage lending. It can also cover cases where the borrower does not reside in the mortgaged property themselves.

With the exception of certain loans to corporate trustees, loan agreements with companies and limited liability partnerships are not regulated mortgage contracts, but lending to English general partnerships can be caught.

¹¹ [Financial Services and Markets Act 2000, section 23.](#)

¹² [Financial Services and Markets Act 2000, section 26.](#)



Restrictions on financial promotions

In addition to the licensing regime under FSMA for firms carrying on regulated financial services activities, FSMA also has a regime that restricts advertisements for financial products – known as financial promotions.

Under [section 21](#) of FSMA, invitations or inducements to engage in investment activity can only be communicated by an authorised person or if the content of the communication has approved by an authorised person.

For these purposes, an authorised person is someone who has been given permission by the PRA or the FCA to carry on a regulated activity.

The financial promotions regime applies to a range of controlled activities, which are defined by the [Financial Services and Markets Act 2000 \(Financial Promotion\) Order 2005](#) – usually known as the Financial Promotion Order (FPO).

One of the controlled activities under the FPO is providing “qualifying credit”, which, in essence, is any credit provided under a regulated mortgage contract.¹³

This means that most advertisements for mortgages, including green mortgages, can only be published by firms that have the necessary permission under FSMA or, alternatively, by an unregulated firm if the content of the advert has been signed off by a regulated firm.

¹³ [Financial Services and Markets Act 2000 \(Financial Promotion\) Order 2005, Schedule 1, Part I, paragraph 10.](#)



Other regulatory requirements

While the framework of the regulatory regime in the UK is set out in primary legislation and in a variety of statutory instruments, much of the detailed regulatory requirements that apply to the day-to-day operations of a mortgage lender or mortgage intermediary are set out in the [FCA's Handbook of Rules and Guidance](#).

For mortgage lenders and mortgage intermediaries, one of the key parts of the handbook is the [Mortgages and Home Finance: Conduct of Business Sourcebook](#) (MCOB).

MCOB sets out regulatory requirements for originating, servicing, arranging and advising on regulated mortgage contracts and applies equally to green mortgages and conventional mortgages.

It imposes high-level conduct of business standards, such as the requirement to act honestly, fairly and professionally in accordance with the best interests of your customer.¹⁴ It also contains detailed rules, such as requirements on the precise wording to be used in any pre-contractual information provided to mortgage borrowers.¹⁵

The regulatory regime under FSMA and the FCA rules applies to green mortgages that match the definition of a regulated mortgage contract. But not all green mortgages will be regulated mortgage contracts.

A green mortgage for a buy-to-let property will generally not meet the definition of a regulated mortgage contract, and will therefore not be regulated by FSMA. This is because of the exemption for “investment property loans” under [article 61A](#) of the RAO. An “investment property loan” is a loan made to a borrower who is acting wholly or predominantly for business purposes and where the mortgaged property is not the borrower's own residence.

Commonly, when a mortgage lender is relying on the exemption for “investment property loans”, the borrower will be asked to sign a business purposes declaration as part of the mortgage documentation.

There are detailed rules on what constitute business purposes in the context of a buy-to-let mortgage contract, but, in broad terms, a landlord with an existing buy-to-let portfolio will



A green mortgage for a buy-to-let property will generally not meet the definition of a regulated mortgage contract, and will therefore not be regulated by FSMA.

generally be regarded as acting for business purposes when they take out a green mortgage over a buy-to-let property.

There is, however, one type of buy-to-let mortgage contract where the exemption for “investment property loans” is not available. That is a consumer buy-to-let (CBTL) mortgage. CBTL mortgages are typically encountered where the borrower is an “accidental landlord”, meaning someone who resorts to renting out their own home because they are unable to sell it or who inherits a family member’s home and decides to rent it out.

A green mortgage to retrofit such a property is therefore likely to be categorised and regulated as a consumer buy-to-let mortgage.

There is a bespoke regulatory regime for consumer buy-to-let mortgages that was introduced in order to comply with the European Union’s Mortgage Credit Directive (MCD).¹⁶ The regime is set out in [Part 3 of the Mortgage Credit Directive Order 2015](#) (MCDO). In essence, it is a lighter-touch form of regulation, when compared with the more detailed regime for regulated mortgage contracts under FSMA.

The regime is overseen by the FCA, but it has more limited rule-making powers in relation to CBTL mortgages. A lender wishing to carry on an activity that would constitute consumer buy-to-let mortgage business must register with the FCA as consumer buy-to-let mortgage firm.¹⁷

The main requirements for CBTL mortgage lenders are contained in [Schedule 2](#) to the MCDO. For the most part, the requirements are watered-down versions of the corresponding MCOB rules. So, for example, there are conduct of business obligations, requirements on pre-contractual information, servicing requirements and rules relating to enforcement procedures.

If a green mortgage meets the criteria for a CBTL mortgage, then the regulatory requirements under the CBTL regime will apply, in the same way that they would for a conventional CBTL mortgage.

¹⁴ [MCOB 2.5A.1R.](#)

¹⁵ [MCOB 5A.5.](#)

¹⁶ [Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation \(EU\) No 1093/2010.](#)

¹⁷ [Mortgage Credit Directive Order 2015, article 9.](#)



Energy performance certificates

For most green mortgages, the borrower will need to provide an EPC, either to demonstrate that the property has the required energy efficiency rating (in the case of a new build) or to demonstrate that retrofitting works have been completed to enhance the property's energy performance (in the case of an existing building).

There are parallel statutory regimes in England & Wales and in Scotland that set out rules for the use and content of EPCs:

England & Wales	Scotland
Energy Performance of Buildings (England and Wales) Regulations 2012	Energy Performance of Buildings (Scotland) Regulations 2008

In addition to the rules governing the use and content of EPCs, there are also separate measures relating to improvements in the energy efficiency of private rented property:

- The [Energy Efficiency \(Private Rented Property\) \(England and Wales\) Regulations 2015](#) prescribe a minimum level of energy efficiency for private rented properties – both domestic and non-domestic. The minimum level of energy efficiency is an EPC rating of “E”. Landlords may not grant a new

tenancy or renew an existing one if its energy performance falls below the minimum level of energy efficiency and also are not permitted to continue letting a domestic property if its EPC rating is below “E”.

- Similar rules were due to be introduced in Scotland under the [Energy Efficiency \(Domestic Private Rented Property\) \(Scotland\) Regulations 2020](#). Those rules would have required all properties in Scotland's private rented sector to have a minimum EPC rating of “E” at a start of tenancy, but their introduction has now been postponed indefinitely due to the COVID-19 crisis.



Tailored regulation for green finance

The UK has a mature system of regulation for mortgage lending and much of the existing regulation works as well for green mortgages as it does for conventional mortgage loans.

However, there are opportunities for the government to introduce further tailored regulatory support in order to encourage growth in the green mortgage market, particularly given the contribution that green mortgages can make toward the goal of achieving net-zero greenhouse gas emissions.

Her Majesty's Treasury (HMT) is required by [section 1JA](#) of FSMA to make periodic recommendations to the FCA about aspects of the government's economic policy to which the FCA should have regard when advancing its objectives and duties. In the

March 2021 remit letter to the FCA, HMT asked the FCA to embed climate change considerations so that every financial decision takes climate change into account.¹⁸

The remit letter stated that the government wishes to deliver a financial system that supports and enables a net-zero economy by mobilising private finance towards sustainable and resilient growth, and is resilient to the physical and transition risks that climate change presents.

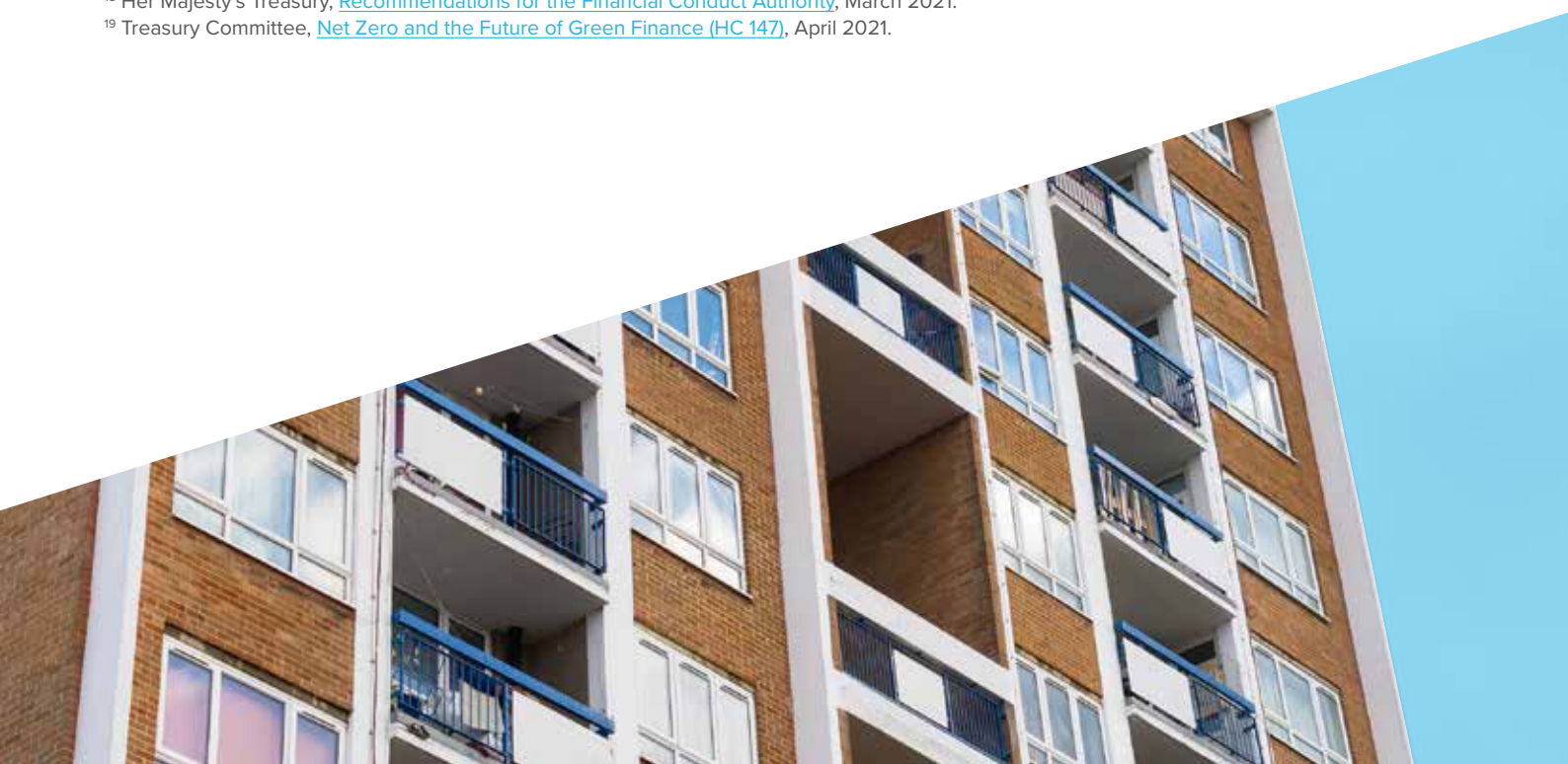
The following month, in April 2021, the Treasury Committee,

which is one of the House of Commons select committees, published a report flagging the importance of the FCA having an appropriate remit, powers, and priorities to prevent the greenwashing of financial products.¹⁹

It is likely that more tailored regulation for green mortgages will be coming down the track soon.

¹⁸ Her Majesty's Treasury, [Recommendations for the Financial Conduct Authority](#), March 2021.

¹⁹ Treasury Committee, [Net Zero and the Future of Green Finance \(HC 147\)](#), April 2021.



Regulatory capital for green mortgages

Prudential regulation is one area where targeted rules for green mortgages may be introduced. Prudential regulation is the set of rules that requires financial firms to control risks by holding adequate levels of capital resources.

Mortgage lenders are subject to prudential regulation. The capital adequacy requirements that apply to mortgage lenders vary according to whether or not the mortgage lender is a credit institution. Credit institutions tend to be banks.

Mortgage lenders that are not credit institutions are subject to the FCA's [Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries](#) (MIPRU). Mortgage lenders that are credit institutions

are subject to prudential regulation under the UK Capital Requirements Regulation²⁰ (UK CRR).

Although the detail of the capital adequacy rules is complex, a proportion of the amount of capital that a lender must hold is generally determined based on an assessment of the risk associated with its lending. This process is called risk-weighting.

Mortgage lenders that are credit institutions may have the option to calculate risk-weighting using either the Standardised Approach or the Internal Ratings-

Based Approach (IRB). The latter only tends to be used by larger institutions and requires the explicit approval of the institution's regulator.

- **Standardised Approach**

For firms using the Standardised Approach, the amount of capital that must be held is determined by applying a standard risk-weighting to each class of exposure. The risk-weighting for retail mortgage exposures is generally 35%.²¹

- **Internal Ratings-Based Approach**

By contrast, firms adopting the IRB approach calculate their capital requirements using their own internal modelling of the probability of default (PD) and the loss given default (LGD).²² For IRB firms, the average risk-weighting for mortgage exposures, at around



10%,²³ tends to be a lot lower than under the Standardised Approach, which means IRB firms have to hold less regulatory capital against their mortgages.

Energy efficiency is typically not considered in most IRB models for residential mortgage exposures, but a Bank of England publication²⁴ has suggested that it could be a relevant factor for risk-adjusted pricing of mortgages on the basis that green mortgages for energy-efficient properties are less frequently in payment arrears than conventional mortgages against energy-inefficient properties.

Separately, there has been industry lobbying for the introduction of a “green supporting factor” that automatically applies a lower regulatory capital charge to green mortgages.

In July 2021, the European Commission announced that it would ask the European Banking Authority (EBA) for an opinion on the definition and possible supporting tools for green retail loans and green mortgages by the second quarter of 2022 and would also explore ways to support the uptake of energy efficient mortgages in the framework of its review of MCD.²⁵

Though the proposals could prove controversial among those who consider that climate policy should not be mixed with prudential policy and that financial-stability norms need to remain rigorously focused on prudential risks.

²⁰ [Regulation \(EU\) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation \(EU\) No 648/2012 \(retained EU law\).](#)

²¹ [UK Capital Requirements Regulation, article 125.](#)

²² [UK Capital Requirements Regulation, article 154.](#)

²³ As of end 2019. Prudential Regulation Authority, [Internal Ratings Based UK mortgage risk weights: Managing deficiencies in model risk capture \(CP14/20\)](#), September 2020, para. 1.7.

²⁴ See footnote 1.

²⁵ European Commission, [Strategy for Financing the Transition to a Sustainable Economy \(COM/2021/390 final\)](#), July 2021.



Government and central bank policy

Even if a green supporting factor is not introduced into the prudential rulebook in the UK, there are other government and central bank policy tools that could be used to support green mortgages.

The UK Government issued its inaugural sovereign green bonds – or “green gilts” – in September 2021. In October 2021, the UK state-owned savings bank, National Savings & Investments launched green savings bonds for retail investors.

Climate change is clearly high on the government’s agenda. There are a couple of targeted policies that could give more confidence to the green mortgage market. One example is a government green loan guarantee scheme.

There have been many government loan guarantee schemes over the years, such as the Coronavirus Business Interruption Loan Scheme and its successor the Recovery Loan Scheme. There have also been schemes specifically targeted at the mortgage market, such as Help to Buy.

It would be possible for the government to develop a Green Loan Guarantee Scheme to help to increase the supply of green mortgages by providing a government-backed guarantee to lenders offering green mortgages.

Another way to increase supply in the green mortgage market would be through a central bank liquidity facility for green mortgages provided by the Bank of England. The Funding for Lending Scheme (FLS) is one example of a central bank liquidity facility. It was launched by the Bank of England in July 2012 and was designed to encourage banks and building societies to expand their lending to households.

The FLS provided central bank funding to lenders for an extended period linked to their lending performance. In simple terms, the more a lender lent, the more central bank funding they received. They also enjoyed a lower cost of borrowing on the central bank funding.

The FLS was successful in increasing the supply of mortgage loans. A Funding for Green Lending Scheme could do the same for green mortgages.

At present, there is no indication that the government is planning a loan guarantee scheme or central bank liquidity facility for green mortgages.





Section 3

How are green mortgages documented?

A mortgage lender offering conventional mortgage products does not need to make significant changes to its customer-facing documentation in order to create a suite of documents for originating green mortgages.

Fundamentally, the documentation used to originate a green mortgage is very similar to the documentation used for a conventional mortgage loan.

Prospective borrowers will apply to a mortgage lender – either directly or via a mortgage broker – using a mortgage application form. That form will capture all of the information required by a lender to make the underwriting decision, such as the personal and financial details of the borrower, the requested amount of the loan, and the address of the property to be mortgaged.

In the case of a green mortgage to purchase a new build property, the application form may also need to capture the EPC rating of the property. For a green mortgage to retrofit an existing property, the form may need to capture details of the proposed energy improvement works.

When the application is made, the borrower will typically be provided with pre-contractual information about the mortgage in a standardised form. Prior to the implementation of MCD in the UK, pre-contractual information was provided by way of a key facts illustration (KFI). But now, for green mortgages which meet the definition of a regulated mortgage contract, the pre-contractual information is provided using a European Standardised Information Sheet (ESIS).

The ESIS for a green mortgage will need to describe the key features of the product and, in particular, explain any additional obligations with which the borrower must comply in order to benefit from the discounted mortgage rate or cashback payment for the green mortgage. The format of the ESIS and the rules for lenders on how to complete an ESIS are set out in [chapter 5A](#) of MCOB.

If the mortgage lender decides to offer a green mortgage, then an offer letter will be issued. Where the green mortgage is a regulated mortgage contract, the lender is usually required to make a binding offer to the borrower and allow them a period of reflection to consider the terms of the offer before accepting it.²⁶

The headline terms of the mortgage will be summarised in the offer letter, but much of the detail of the parties' rights and responsibilities will be set out in the lender's mortgage terms and conditions, which will be incorporated in the offer letter by reference. The mortgage terms and conditions are often provided to the borrower as a separate booklet.

In England and Wales, the security over the mortgaged property is created by a mortgage deed signed by the borrower. In Scotland, the document is called a standard security. In both jurisdictions, the solicitor or conveyancer acting on the mortgage will need to register the mortgage security at the relevant land registry after completion.

²⁶ [MCOB 6A.3](#).

Most mortgage lenders instruct a solicitor or conveyancer using the standardised instructions set out in the UK Finance Mortgage Lenders' Handbook, which used to be known as the CML Handbook, until the Council of Mortgage Lenders merged into UK Finance. There are separate handbooks for [England and Wales](#) and for [Scotland](#).

Both handbooks have a part 1 of general instructions and part 2 of lender-specific instructions. The handbook for England and Wales also includes a part 3, which sets out standard instructions to be used where a solicitor or conveyancer is representing the lender but not the borrower.



Practical tips for documentation

One of the practical points for a lender to consider when developing a green mortgage product is its internal process for capturing and verifying energy performance data relating to the mortgaged property, bearing in mind the prospect that mortgage lenders may have to disclose energy performance data on a portfolio-wide basis in the future. Capturing this information will require changes to the application form or the broker portal if mortgage applications are submitted by intermediaries.

A separate set of mortgage terms and conditions may be required for a green mortgage product in order to explain when the discounted interest rate applies or what the process is for claiming cashback. For lenders who are active in the Scottish market, it is important to remember that mortgage conditions are usually filed in Scotland at a public registry called the [Books of Council & Session](#). In order to complete the filing, one copy of the mortgage conditions will need to be produced in Scottish deed form and signed in wet-ink by an officer of the lender. There is a small registration fee for making the filing and the process can usually be completed within a fortnight.

If the lender has a separate set of mortgage terms and conditions for its green mortgage product, then it will also need a separate form of mortgage deed or standard security.

Lenders in the English market will usually apply to Her Majesty's Land Registry to have the template form of mortgage deed pre-approved. There are a number of benefits in having the template form of mortgage deed pre-approved. An "MD" reference number will be allocated and that should be included on the template when it is rolled out for use. This allows staff at the Land Registry offices to access the lender's details from a computer database, which speeds up registration and reduces the incidence of clerical errors. Guidance on applying for approval of mortgage documentation is available on the Land Registry's website.²⁷

When launching a new green mortgage product, it is also important for the lender to review their Part 2 instructions for solicitors. The Part 2 instructions are the lender-specific instructions which tie in with the general instructions in the UK Finance Mortgage Lenders' Handbook. Updating the Part 2 instructions is often overlooked, but it is likely that some adjustments will be required for a green mortgage product.

Finally, the lender should ensure that its operations teams and any legal firms that handle its bulk mortgage work – for example, any fees-free remortgage service – are notified that new documentation is being launched for a green mortgage product. It is essential that the correct set of terms and conditions is provided to borrowers. If a borrower is not provided with the correct documentation – for example, if the borrower receives the terms and conditions for a conventional mortgage rather than a green mortgage – the mortgage may not be enforceable.

A provision of a mortgage agreement that purports to bind a customer to a set of mortgage terms and conditions they have not seen is generally regarded as an unfair term and therefore not enforceable under the [Consumer Rights Act 2015](#).²⁸

²⁷ [Practice guide 30: Approval of mortgage documentation](#).

²⁸ [Consumer Rights Act 2015, Schedule 2, Part 1, paragraph 10](#).



Section 4

How are green mortgages funded?

The most common methods for funding green mortgages are:

- Deposits
- Unsecured notes
- Covered bonds
- Mortgage-backed securities
- Forward flow agreements
- Mortgage warehouse financings

Deposits

Accepting deposits is a PRA-regulated activity,²⁹ so this funding method – where the lender uses money deposited with it by savers – is only available to banks, building societies and other deposit-taking institutions. Many high-street mortgage lenders are authorised deposit-takers, but a lot of specialist mortgage lenders are not.

Even mortgage lenders that are deposit-taking institutions will often rely on a mix of funding sources to finance their mortgage lending.

Unsecured notes

Mortgage lenders may borrow to fund green mortgages by issuing unsecured notes. The notes can either be senior or subordinated. If the lender fails, senior notes enjoy a higher priority in the issuer's insolvency and are paid out before subordinated notes. This means that subordinated notes typically have a higher rate of interest – or coupon – because the investor takes more risk.

- **Example – Tier 2 capital**
March 2021 saw the first issuance of subordinated green notes by a UK bank. That note issuance raised £150 million and the proceeds will be used by the bank to make green mortgages for buildings with an “A” or “B” EPC rating.

The issuance followed the framework of market standards and voluntary guidelines set out in the Green Bond Principles.

A leading ESG ratings provider was appointed to independently verify compliance with the Green Bond Principles and issued its findings in a document called a Second Party Opinion.

²⁹ [Financial Services and Markets Act 2000 \(PRA-regulated Activities\) Order 2013, article 2\(a\)](#).

Covered bonds

Covered bonds are a type of secured bond that is backed by a pool of assets, such as a portfolio of green mortgages. The asset pool of a covered bond is dynamic and so green mortgages that are redeemed or fall into arrears can be replaced with new green mortgages of similar credit quality and characteristics, for as long as the issuer of the bond remains solvent. The UK has a regulated covered bond regime overseen by the FCA,³⁰ which means that covered bonds can have a preferential prudential risk-weighting.

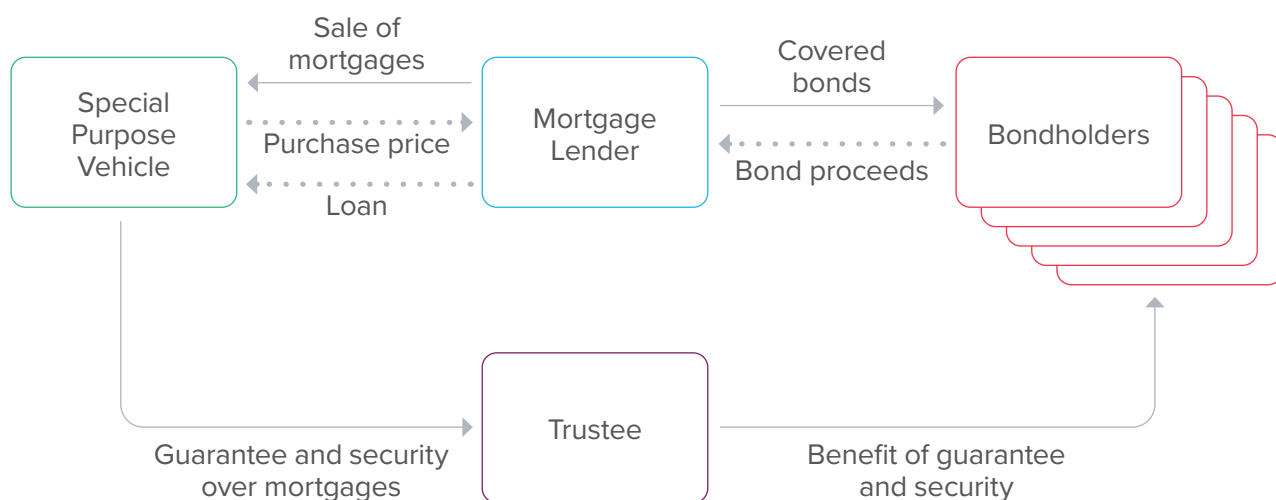
A simplified structure of a covered bond issuance is shown in the diagram below. Under this structure, the bonds are issued

directly by the mortgage lender, who uses the proceeds of those bonds to make a loan to a special purpose vehicle. The special purpose vehicle uses that loan to buy a portfolio of mortgages from the mortgage lender, which acts as collateral for the bond issuance.

Covered bonds are typically rated by a credit rating agency. Once the bonds have been issued they are usually publicly listed and admitted to trading on a stock exchange and a prospectus will typically need to be published for that purpose. The bonds are usually deposited with a clearing system and then transferred between investors in book-entry form.

A mortgage lender will usually engage an investment bank to arrange the structure of the covered bond programme and help find investors to acquire the bonds.

The sale of the mortgages under a covered bond programme does not result in a transfer of legal title in the ordinary course, so the mortgage lender remains the lender of record and continues to service the portfolio of mortgages. Legal title to the portfolio usually only transfers upon specified perfection events, such as the insolvency of the mortgage lender.



³⁰ [Regulated Covered Bonds Regulations 2008](#).

Mortgage-backed Securities

Mortgage lenders can also raise funds by issuing mortgage-backed securities by way of a securitisation. Securitisation is a structured finance technique that provides for the ring-fencing of a pool of income-generating assets, like green mortgages, and the transfer of cashflows from such assets to investors.

Under a securitisation, investors in the debt capital market buy notes issued by a special purpose vehicle that uses the proceeds of those notes to buy a portfolio of mortgages from the mortgage

lender. A simplified structure of the transaction is shown in the diagram below.

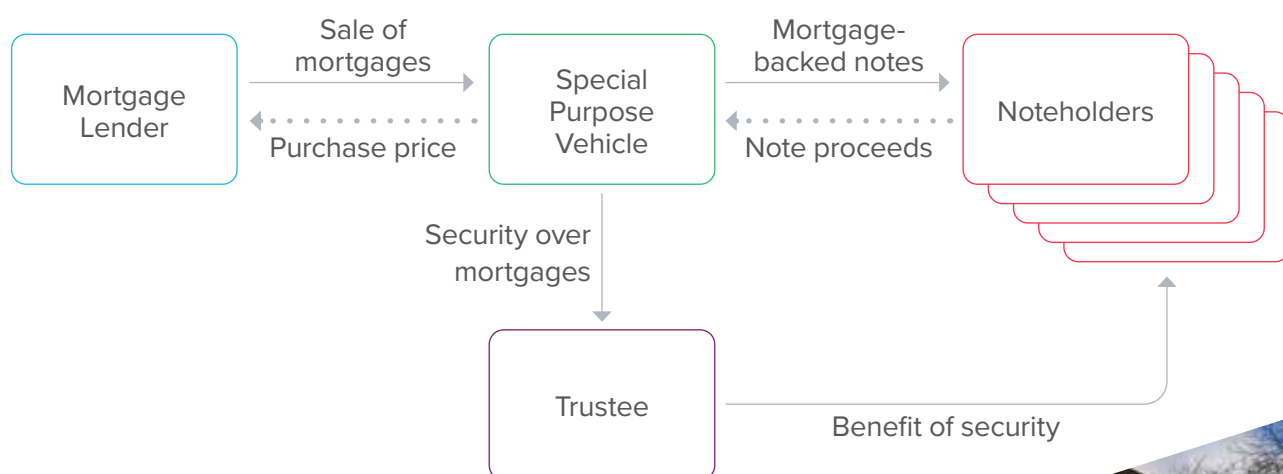
The notes issued under a securitisation also tend to be rated, publicly listed and traded on a stock exchange. Transfers between investors of interests in mortgage-backed notes are also usually done in book-entry form through a clearing system.

As under a covered bond programme, the sale of the mortgages does not result in a transfer of legal title in the

ordinary course, so the mortgage lender remains the lender of record and continues to service the portfolio.

- **Example**

The first issuance of securitised green bonds by a UK mortgage lender followed in June 2021, raising £640 million. The proceeds of the securitisation were again used to fund green mortgages for buildings with an “A” or “B” EPC rating and the issuance followed the Green Bond Principles as verified by way of a Second Party Opinion.

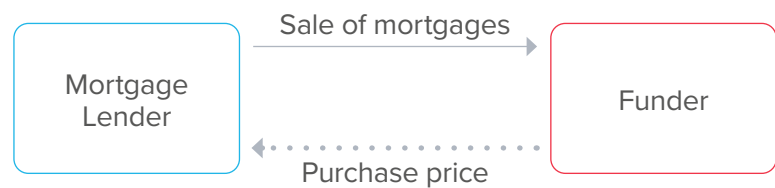


Forward flow agreement

A forward flow agreement is a simpler structure and is shown in the diagram below. Under a forward flow agreement, a funder buys mortgages from the mortgage lender on an ongoing basis under an arrangement where the mortgage lender remains the lender of record and servicer.

Forward flow agreements are particularly attractive for new entrants to the mortgage market, because the funder will typically fund 100% of the mortgages. This

is appealing because it means the mortgage lender can kick-start origination and build up a pipeline of mortgage applications without using its own funds.



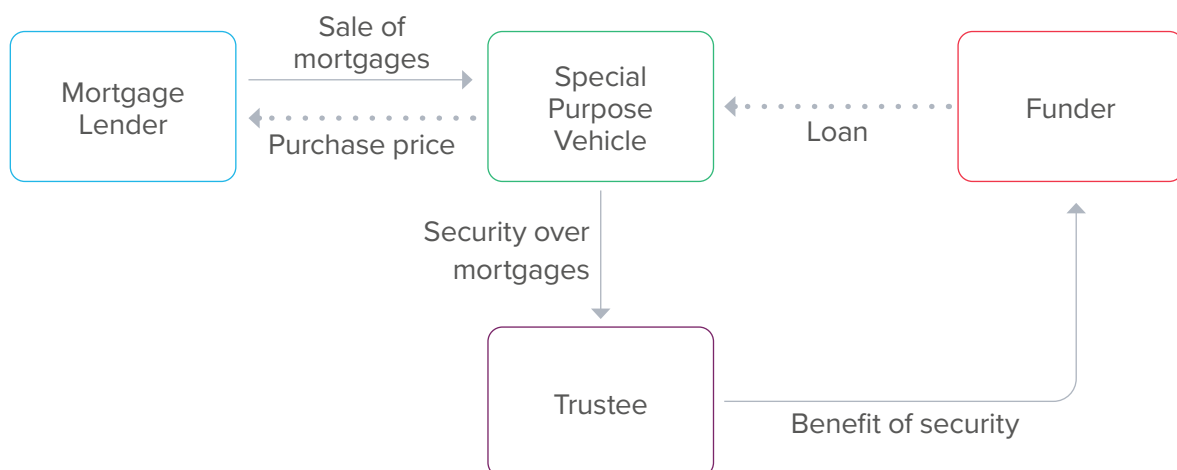
Mortgage warehouse financing

The diagram below shows a mortgage warehouse financing. Warehouse financing involves the provision of a loan by a single funder or small group of funders to a special purpose vehicle to buy mortgages from a mortgage lender on an ongoing basis under an arrangement where

the mortgage lender remains the lender of record and servicer.

A warehouse financing may be used as a temporary financing solution in order to build up a large enough portfolio of mortgage loans in order to securitise.

Typically a warehouse funder will only cover a proportion of the funding for the mortgage loans, so the mortgage lender may need to commit its own funds to the special purpose vehicle as well.



Practical tips for funding arrangements

There are a few practical points to note on the funding arrangements for green mortgages.

With the exception of funding by way of bank deposits or unsecured notes, most funding structures involve a beneficial sale of mortgages. It is therefore critical that mortgage terms and conditions permit the lender to transfer its rights under the mortgage agreement.

Funders will conduct due diligence on a mortgage lender's internal processes and customer-facing documentation before committing to fund, so those processes and documentation need to be sufficiently robust to withstand the scrutiny of a third

party. Good record-keeping will make the due diligence exercise run more smoothly.

If the chosen funding method involves the issuance of green bonds, the mortgage lender will have to supply periodic reports to investors on how the proceeds of the green bonds have been used. The mortgage lender may need to develop new internal systems to deliver those investor reports.

The lender may also want to develop a green bond framework and engage an external review provider to issue a Second Party Opinion independently verifying compliance with any market standards which are being adopted, such as the Green Bond Principles.

Having a clear funding strategy in advance of launching a green mortgage product means a mortgage lender can develop the product in parallel with the funding arrangements and avoid the need to change the product at a later date to meet a funder's preferences.

• Checklist

- Transferability under the mortgage agreement
- Robust processes and documentation
- Record-keeping for due diligence and reporting
- Develop a green bond framework
- Engage an external review provider





Glossary

BEIS	Department for Business, Energy and Industrial Strategy	KFI	Key Facts Illustration
CBTL	Consumer buy-to-let	LGD	Loss given default
COP26	26th Conference of the Parties to the United Nations Framework Convention on Climate Change	LMA	Loan Market Association
EBA	European Banking Authority	LTV	Loan to value
EPC	Energy Performance Certificate	MCD	Mortgage Credit Directive
ESG	Environmental, Social and Governance	MCDO	Mortgage Credit Directive Order 2015
ESIS	European Standardised Information Sheet	MCOB	Mortgages and Home Finance: Conduct of Business Sourcebook
FCA	Financial Conduct Authority	MIPRU	Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries
FLS	Funding for Lending Scheme	PD	Probability of default
FPO	Financial Services and Markets Act 2000 (Financial Promotion) Order 2005	PEA	Predicted Energy Assessment
FSMA	Financial Services and Markets Act 2000	PRA	Prudential Regulation Authority
HMT	Her Majesty's Treasury	RAO	Financial Services and Markets Act 2000 (Regulated Activities) Order 2001
ICMA	International Capital Market Association	SDGs	Sustainable Development Goals
IIF	Institute of International Finance	SDR	Sustainability Disclosure Requirements
IRB	Internal Ratings-Based Approach	TCFD	Task Force on Climate-related Financial Disclosures



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