How "Green" are Green Loans?

12 June 2024

The European Banking Authority (the EBA) published its report on green loans and mortgages (the Report) in December 2023. This was done in response to an earlier call for advice from the European Commission. We discuss the main themes of the Report and the EBA's proposals.

Green loans defined

According to the Report, credit institutions' green loans are on average accounting for 4.5% of their total loans. Lack of a common definition and rules on credit institutions' green lending are two of the main obstacles to the growth of green loan markets.

Although there is no widely used standard or label applying specifically to green loans, the EBA note the Loan Market Association's '*Green Loan Principles*'. These principles have become a leading framework in green lending among credit institutions. There is also a plethora of legislation at EU level, most notably the EU Taxonomy. This provides "*a classification system for environmentally sustainable activities to ensure the environmental integrity and sufficient ambition to achieve the EU objectives*". However, the EBA stresses that the absence of a common EU definition of green loans poses a risk of mis-selling. The absence of such a definition means it is difficult for consumers to identify and compare different 'green loan' products. Introducing a common EU definition would ensure that consumers are aware of the variety of products available. It would also introduce standardised criteria to access the market, providing clarity and certainty to lenders.

Proposal for a common framework on green loans

The EBA explains that a green loan definition should not be based solely on the EU Taxonomy. The technical screening criteria of the EU Taxonomy are strict and exclude a large volume of activities contributing to the transition of the economy. Also, the framework does not capture the existing large volume of economic activities improving the existing conditions and supporting the transition but not aligned with all the relevant screening criteria. For this reason, a green loan definition based solely on the EU Taxonomy would exclude a large number of loans that credit institutions identify as green.

Therefore, the EBA recommends that the European Commission consider two options when introducing a definition for green loans:-

1. A recommendation for credit institutions on the processes and criteria to define green loans based on the EU Taxonomy, or
2. A legislative proposal for credit institutions on the processes and criteria to define green loans based on the EU Taxonomy, mirroring the structure and features of the regulation on EU green bonds.

The second option is supported by the EBA. The Report explains how a green label based on the legislation could be structured, namely through a tiered approach:

- The first tier would categorise loans for which the proceeds are allocated to economic activities in line with the EU Taxonomy and its technical screening criteria, at the point of origination of these loans.

- The second tier would cover loans where the proceeds are not aligned with the technical screening criteria of the EU Taxonomy at the point of origination. Instead, they would be allocated to economic activities with a dedication transition purpose.

Green loan origination and monitoring process

To complement the EBA's existing '*Guidelines on loan origination & monitoring'* (*EBA/GL/2020/06*), the final section of their Report provides policy suggestions to credit institutions. These suggestions focus on their green loan origination and monitoring processes.

The EBA advise that:

- The Mortgage Credit Directive integrate the concept of green mortgages. It should also incorporate the sustainability features of properties. For example, the Energy Performance Certificate (EPC) could be used to secure loans as part of their requirements.
- Pre-contractual information could include information on the EPC in addition to other relevant information about the property to secure the loan. The pre-contractual information would aid the consumer in understanding their obligations. This understanding is necessary in order to benefit from special conditions under the green mortgage such as discounted rates.

The EBA explains that the pre-contractual information would improve transparency. It would also provide an open dialogue between prospective borrowers and credit institutions. This dialogue would help determine whether further investment is required to increase the energy efficiency of the borrower's property.

Conclusion

The EBA's report highlights the need for increased regulation to provide clarity and consistency regarding green loans. This increased clarity and certainty would likely facilitate the further growth of the green loan market. While the Loan Market Association (LMA) has introduced draft provisions for documenting sustainability-linked loans, no provisions have been introduced for greens loans. This is despite green loans having a much more limited application. We would expect that the implementation of the EBA guidance on green loans would facilitate the LMA in introducing draft provisions for green loans also.

For more information contact a member of our Banking or ESG teams.

The content of this article is provided for information purposes only and does not constitute legal or other advice.