Upgrading housing: the potential and limits of borrower-based measures

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ECMI / NBS / CEPS / SUERF Research Conference 2025

1-2.10.2025, Bratislava

Overview

- BBMs and housing upgrade – Financial stability and climate objectives
- The Slovakian, Latvian and Hungarian schemes
- Survey results
- Tentative conclusions

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The need of housing upgrade

- **40%*** of the EU's total energy consumption because of buildings
- **Approximately 1/3** of the EU's greenhouse gas emissions from energy because of buildings
- **Over 75%** of EU buildings are energy inefficient
- **85% – 95%** of the buildings existing today will still be in use in 2050
- **Around EUR 275 billion** in additional investments are needed per year, for renovation only, to achieve the EU's 55% emission reduction target by 2030
- Many owners have limited financial resources and liquidity to finance large-scale renovations or acquire energy-efficient houses
- Access to bank loans is crucial to engage in housing upgrade investments, especially in countries where other funding is scarce

* All numbers from the European Commission (2020) report

Borrower-Based Measures (BBMs)

- BBMs are designed mainly to prevent the excessive increase of loans, excessive over-indebtedness (of households) and related real estate market imbalances
- Main BBMs used consist of
  - Loan-to-Value (LTV) limits
  - Debt-to-Income (DTI) limits
  - Debt Service-to-Income (DSTI) limits
  - Loan maturity limits
- They aim to avoid stretching balance sheets ex-ante and, to a lesser extent, curtail borrowers who may be forced to default ex-post in response to adverse shocks
- To some extent, they also impact the credit and RRE cycle
- Empirical findings show that BBMs are effective in reducing households' probability of default as well as loss given default

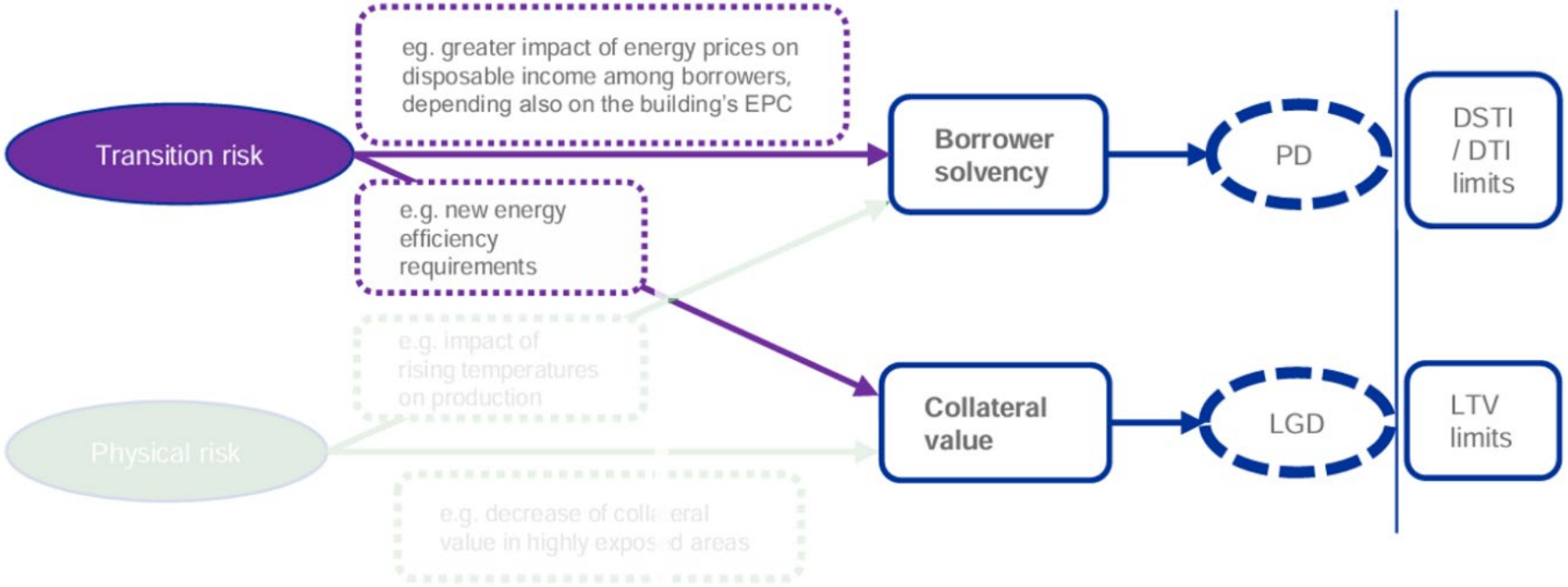
BBMs and housing upgrade

- Reducing housing GHG emissions is central to achieving the EU's climate objective. A 40% reduction compared to 2022 is necessary until 2030

- This represents a transition risk for the countries' mortgage market, which should be accounted for in BBMs

- At the same time, BBMs can be a hurdle for countries' climate objectives because they limit funding to upgrade housing

Transmission channels of climate risks to BBMs



Source: ECB/ESRB (2023) Report

Different risk perspectives

$$Expected\ Loss = EAD * PD * LGD$$

Transition risk is a **new financial risk** for borrowers with non-energy-efficient houses

Households will spend more on energy → PD ↑

Houses will lose value → LGD ↑

Tighten DTI, DSTI

Tighten LTV

Transition risk is a **new financial opportunity** for borrowers with energy-efficient houses

Households will spend less on energy → PD ↓

Houses will gain value → LGD ↓

Ease DTI, DSTI

Ease LTV

View depends on what is already accounted for in BBMs

A climate objective perspective

- BBMs can be a hurdle to get funding for upgrading housing
- Relaxing BBMs for targeted housing-upgrade loans support climate objectives
- Trade-off with financial stability? It depends on the view taken on risk
- The Capital Requirements Regulation (CRR) III proposal clarifies that modifications made to a property that improve the energy efficiency of the building or housing unit must be considered as unequivocally increasing its value
- Impact on energy efficiency is also a parameter to consider in the equation

How can it be risk-neutral for banks?

- If a housing upgrade generates energy-cost savings that are not currently accounted for in the household's income (PD)

- If a housing upgrade alleviates property valuation pressures from significant investment needed to align energy efficiency with general regulatory or market expectations (LGD)

- If a housing upgrade is backed by public support programs (fiscal or other schemes aimed at risk reduction), making them less risky for banks
  - Caveat: public support programs might increase portfolio concentration by relaxing lending standards

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BBM frameworks

	DTI	DSTI	LTV	Maturity
Slovakia	**Ratio of 8** (exceptions: ratio of 9 for 5 percent of loans to lower-income clients younger than 35 years old and progressive tightening of ratio for clients older than 40 years old)	**Limit of 60%** for housing and consumer loans (exceptions: 70% for 5 percent of new loans).*	**Limit of 80%** (exceptions: 90% for 20 percent of new loans)	Limits at **8 years** for consumer loans and **30 years** for housing loans.
Latvia	**Ratio of 6** for all housing and consumer loans	**Limit of 40%** for all housing and consumer loans	**Limits of 90%** for housing loans to consumers exceeding 100 minimum wage (exceptions: 95% for housing loans secured by a state guarantee, 70% for buy-to-let housing loans or similar)	Limits at **7 years** for consumer loans and **30 years** for housing loans
Hungary		**Limit from 10% to 60%** **d**epending on the loan purpose, the currency, the borrower's income and the maturity and interest rate fixation period.	**Limit from 30% and 80%** depending on the loan currency and the type of loan - mortgage, vehicle loans (exceptions: 85% for financial leases and 90% for first-time buyers)	

*Income is defined as disposable income - i.e. net income less minimum subsistence costs.

Housing upgrade BBM changes

		DTI	DSTI	LTV	Maturity
Slovakia	2023		Maximum instalment implied by actual DSTI limit (60%) increased by 50 €		Maximum maturity extended from 8 to 10 years
Latvia	2024	Ratio up to 8 from 6	Up to 45% from 40%		
Hungary	2025		Up to 60% from 50% regardless of the income threshold for HUF loans with at least 10 years' fixed rates or maturity	Up to 90% from 80% for HUF mortgages and leases	

Climate and financial stability objectives

	Objective	Risk management	Eligibility
Slovakia	Cofinancing of house renovation from EU Recovery and Resilience Facility	Strict risk neutrality based on expected savings in energy expenses. Reflecting the longer-term effects of higher value of houses after renovation	Renovation qualifies Slovak Environment Agency scheme (e.g. save primary energy by at least 30%)
Latvia	Facilitating a structural shift in lending for energy-efficient housing	Reflect the saved costs for utilities for households in energy-efficient vs. energy-inefficient housing	Energy Efficiency Certification (EEC) ranges from A+ to C
Hungary	Improve the transition risk sensitivity of the BBM regulation by providing more room to upgrade the energy efficiency of dwellings without materially increasing credit risk	Lower maintenance costs allow larger proportion of income on loan repayment. Demand for green real estate is more resilient compared to less efficient real estates	Real estate purchases and loans for renovation purposes that finance the purchase and construction of energy-efficient apartments and efficiency-enhancing renovations

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Bank survey

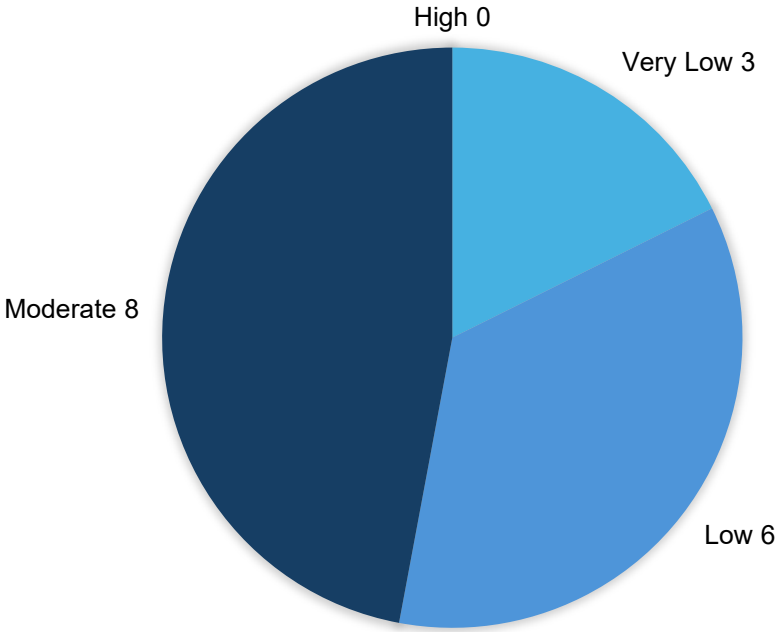
- Survey answered by 16 banks, the largest banks in each country
  - Slovakia: 3 banks
  - Latvia: 6 banks
  - Hungary: 7 banks

- Questions on green loan offerings, institution's practices, **green loan market prospects**, and **impact of green BBMs**

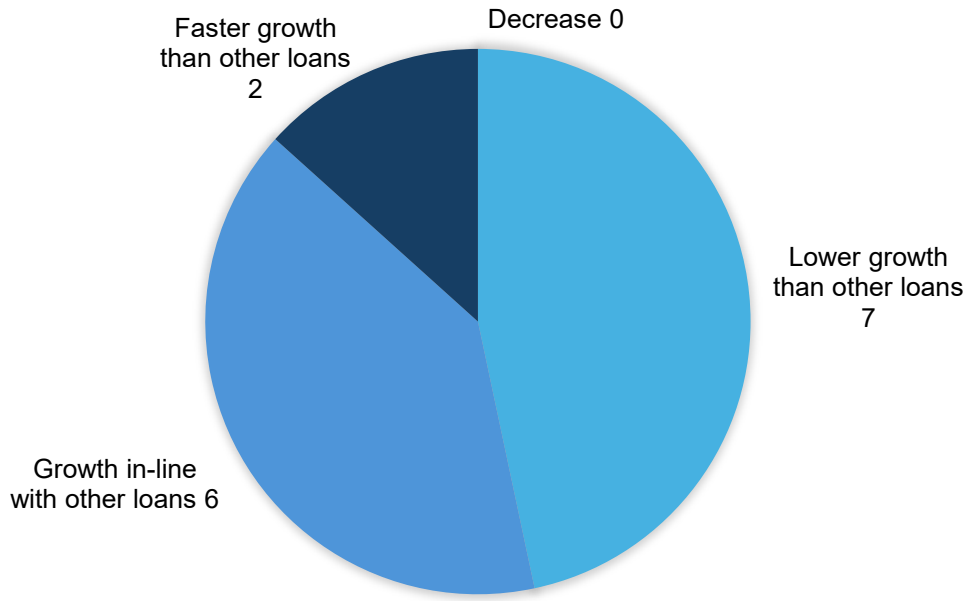
- Note: questions for Hungary are formulated in terms of banks' expectations since the measure started 1 month before the survey

Current and expected demand for green loans

CURRENT DEMAND

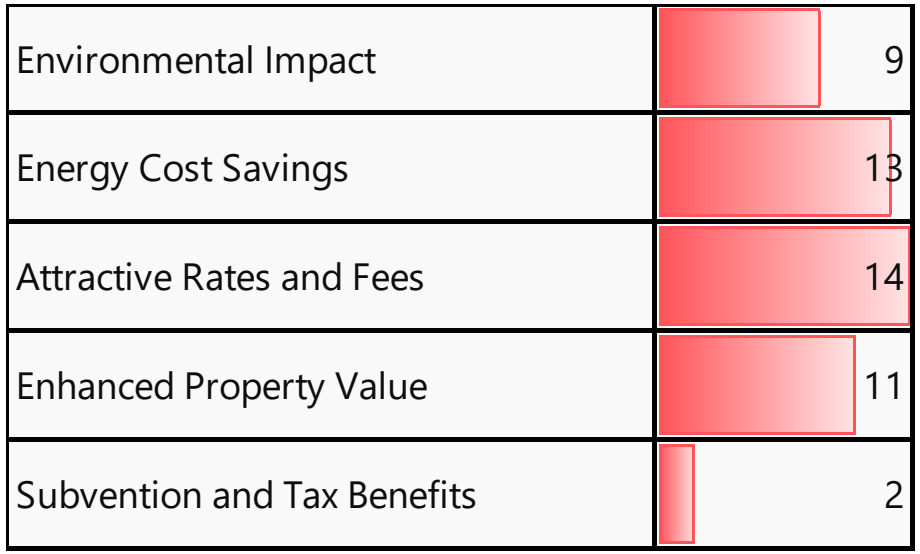


EXPECTED DEMAND FOR GREEN LOANS (OVER THE NEXT 3–5 YEARS)



Marketing and potential drivers of future demand

Key messages banks emphasize when marketing green loans



Selected factors driving future demand for green loans

	No impact	Small impact	Significant Impact
Policies or subsidies promoting energy-efficient construction, renewable energy projects, or eco-friendly renovations	0	2	15
Growing consumers' awareness of environmental issues and desire for eco-friendly products	0	10	5
Financial savings from energy-efficient upgrades, such as reduced utility costs for energy-efficient homes	0	3	13
Banks offering attractive, competitive green credit products to differentiate themselves	0	7	10
Less favourable tax and financial credit conditions for non-renewable energy projects or less energy-efficient homes	2	7	8
Lower interest rates or tax benefits associated with green credit products	0	5	12
Worries about possible asset depreciation or difficulties to sell non energy-efficient assets	1	13	2

The importance of selected barriers to the growth of the green loans market

	Not important	Moderately important	Important
Lack of consumer awareness and understanding of green loans	0	9	7
Upfront expenses for green projects even with loan availability	2	5	9
Lack of attractive pricing, such as reduced interest rates or fees, to motivate borrowers	0	8	9
Absence of clear government support or subsidies or risk of changes in current policies	0	5	12
Difficulty in defining and certifying what qualifies as a green loan or project	2	6	8
Limited bank capacity and expertise	7	4	5
Low supply of green projects and real estate	2	6	9

Changes in demand and the purpose of use

Observed/expected changes in the demand after regulatory adjustments

No change in demand	7
Increase in demand, no contribution from regulatory changes	0
Increase in demand, marginal contribution from regulatory changes	7
Increase in demand, significant contribution from regulatory changes	0
Do not know / No opinion	2

(Expected) purpose of the green loans made possible by the regulatory adjustments

	Not relevant	Moderately relevant	Importantly relevant
To finance the purchase of real estate with better energy efficiency	2	3	10
To finance renovation/retrofitting related to energy efficiency	3	4	7
To finance real estate purchases not related to energy efficiency improvements	10	2	1
To enter the credit market only due to the availability of preferential regulatory adjustments	10	3	0

Impact on credit risk

Expected impact of the relaxation on the credit risk profile of green loans

Significantly increase risk	0
Moderately increase risk	3
No impact on risk	9
Moderately decrease risk	2
Significantly decrease risk	0
Do not know / No opinion	2

PDs and LGDs of green loans compared to other similar loans

	Probabilty of default for green loans	Loss given default for green loans
Lower than for other loans	3	1
Similar to other loans	10	9
Higher than for other loans	0	1
Do not know / no opinion	3	4

Potential helpful prudential regulatory measures to support sustained growth in green lending

- Capital relief for green loans (most frequent answer)
- Lower liquidity requirements (or for Net Stable Funding Ratio)
- Simpler eligibility checking process (transparent, unified tool, data, templates)
- Subsidized administrative process
- Scheme for Buy-and-Renovate (subsidized)
- Lower property tax

Tentative conclusions

- **Green BBM adjustments are likely to support environmental objectives only marginally** (they affect only a limited pool of people engaging in housing upgrades)
- **Green BBM adjustments do not per se provide a financial incentive for engaging in housing upgrade** (they only unlock more funds for those who want to engage in housing upgrade)
- **Green BBM adjustments could be a complement to other public policies that provide financial incentives for housing upgrade** (in order not to limit the impact of these incentives for some constrained households)
- **Green BBM adjustments' impacts could be greater with measures to reduce the cost and complexity of due diligence and administrative processes**

Thank you very much for your attention!

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