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AUGUST 2014

Giving credit where credit is due

CONSUMER FINANCE FOR LOW-CARBON INVESTMENTS

The UK Committee on Climate Change (CCC) recently published a Frontier report[1] on how the cost and unavailability of finance is inhibiting the take-up of new low-carbon technologies amongst consumers. This bulletin examines the market for low-cost finance, and suggests ways in which the existing "Green Deal" incentives could be improved.

To meet its ambitious targets for carbon reduction, the UK Government needs to secure big changes in consumer behaviour, leading to much greater energy efficiency, the use of renewable heat sources and electric cars. But the investment needed to make these changes is beyond the reach of many consumers, who lack access to low-cost finance. The "Green Deal" scheme

[1] Available at: http://www.frontier-economics.com/documents/2014/07/rpt-ccc-cost-of-capital-frontier-report.pdf

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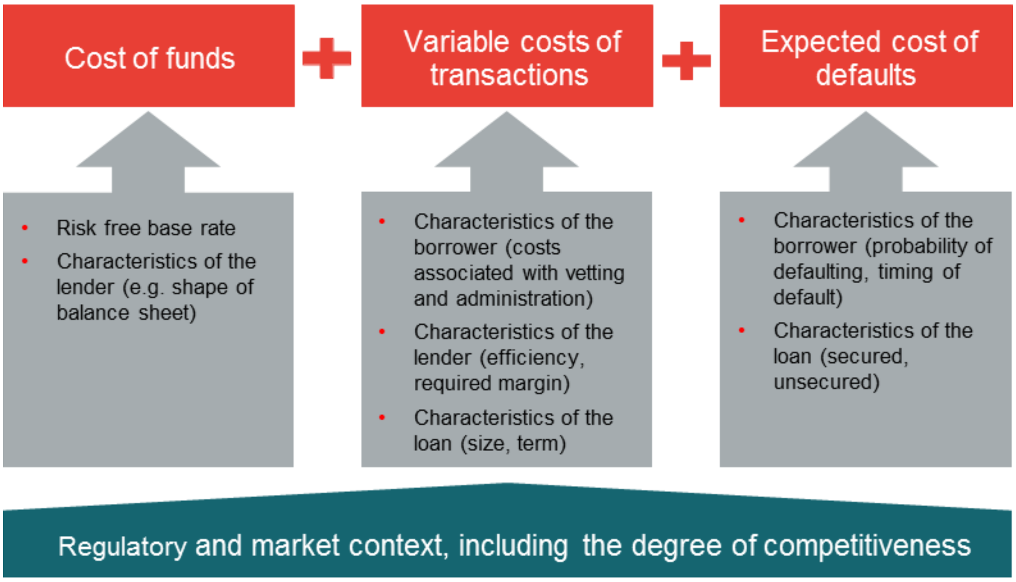
introduced by the Department for Energy and Climate Change (DECC) to address this problem has achieved a very low take-up so far. Only 3,757 Green Deal carbon-saving measures were put in place between the launch of the scheme at the start of 2013 and June 2014, in a total of only 1,587 households.

COUNTING THE COST

To understand what drives the cost of household finance for such investments, it is helpful (see Figure 1) to break it into three elements: the cost of funds; the variable costs of the transaction; and the expected cost of default.

Figure 1. Drivers of the cost of household finance



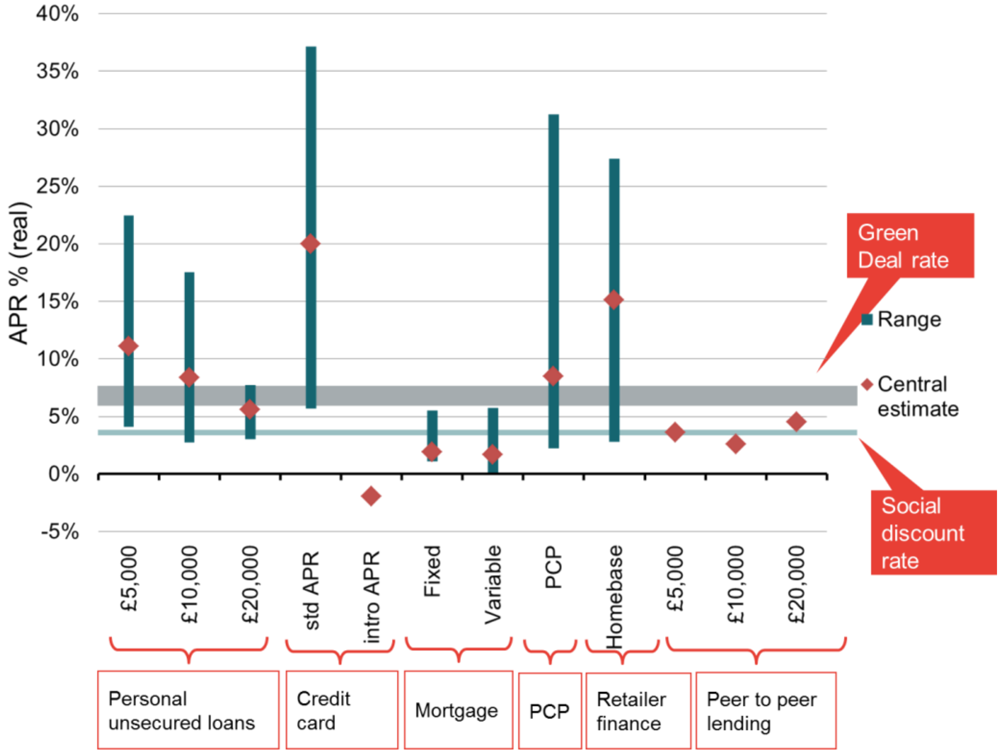
Source: Frontier Economics

The main driver of variations in cost between different financial products is the expected cost of default. This is why secured products (e.g., mortgages) are typically supplied at lower interest rates than those where there is no security, such as a house or car, associated with the loan.

Similarly, default costs are the main driver of variations in the cost of finance between different types of consumers. The price at which a consumer can borrow depends significantly on his or her credit history, and other characteristics associated with the likelihood of default. Indeed, many loan products are not available at all to consumers with a poor credit history.

The level and range of interest rates in recent (spring 2014) markets, shown in Figure 2 on the next page, illustrates the importance of default costs.

Figure 2. Interest rates across different financial products (real)



Source: Frontier Economics for the Committee on Climate Change

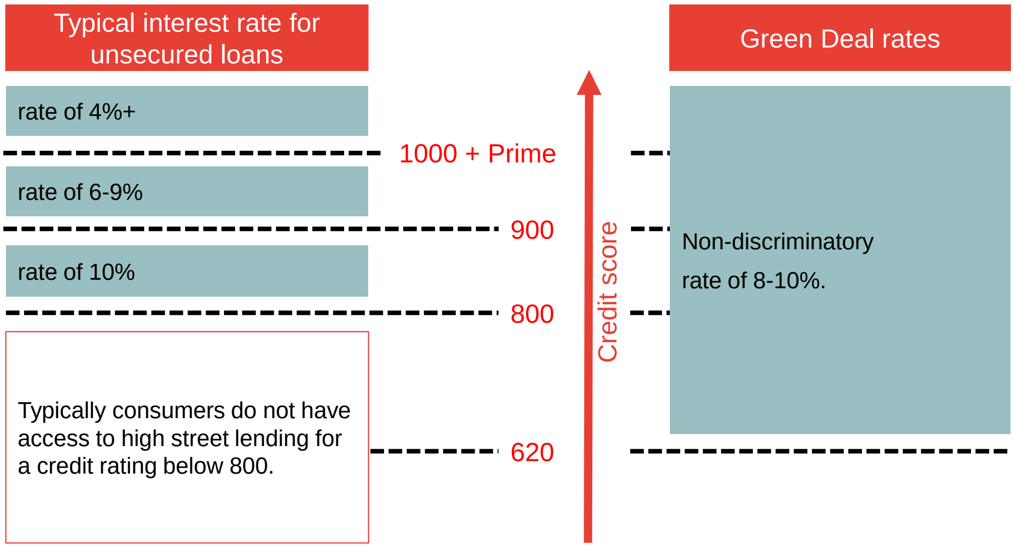
Note: The assumptions underlying the analysis are detailed in our report for the CCC. Rates for most of these products are likely to rise as the Bank of England base rate rises and as the effects of the Funding for Lending scheme unwinds. The Green Deal interest rate already factors this in, because it offers a long-term fixed rate.

Moreover, the availability of products with the lowest interest rates is limited to a subset of consumers. For example, top-up mortgages are limited to homeowners with a sufficiently low loan-to-value ratio. Low credit card interest rates are normally limited to introductory periods, and constant switching to achieve these may have a negative effect on the borrower's credit rating.

TRY AGAIN

The Green Deal sought to overcome this problem by providing for a loan to be secured against the energy bill of the property. This offered the possibility of secured lending to consumers with no other security to offer. Green Deal loans are also offered (subject to some minimum requirements) to consumers irrespective of their credit score - at the same interest rate. As a result, they are in theory available to 83% of the population. The wide coverage of the Green Deal is illustrated in Figure 3. And yet, as we have seen, very few households have managed to make use of the scheme so far.

Figure 3. Indicative lending rates by credit score



Source: Frontier Economics, based on industry engagement

CONCLUSION

With such a clear rationale, the Green Deal idea is certainly worth persevering with. One blockage seems to have been the "Golden Rule", namely that the expected financial savings must equal or exceed loan repayments. DECC is already looking at ways of making this rule less inflexible. And in Frontier's work for the CCC, we looked at further options, of which two are outlined below.

- **Lowering the interest rate.** The Green Deal Finance Company (GDFC) has a comparatively high cost of funds, which is then reflected in its interest rates. This could be due to its risk being mis-priced, because of its lack of track record as a lender. A time-limited Government guarantee of the GDFC's borrowing would enable it to establish a track record, reducing its cost of funds both before and after the guarantee ends.

- **Broadening the coverage.** Currently, payments from the Renewable Heat Incentive and feed-in tariffs cannot be counted in the calculation of the Golden Rule. If these payments could be included, the eligibility of Green Deal loans for the associated technologies would increase.

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