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T21

CREDIT TOOLS TO PROMOTE ENERGY CONSERVATION:

A POSSIBLE FEDERAL ROLE

MASTER

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1.0 Introduction

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This paper is an analysis of the potential of banking institutions to assist in the promotion and implementation of energy conserving measures. Particular emphasis is given to urban problems and to a possible federal involvement with any measures taken.

The relationship between commercial banks and their borrowers was examined because it appears to offer a significant opportunity to stimulate energy conservation practices. Additionally, in order to assess a potential federal role, existing regulatory mechanisms were examined. In the case of commercial banks, the regulatory bodies are the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

Several concurrent efforts were undertaken. First, senior officers of commercial banks were interviewed. The purpose of these interviews was to develop an understanding of how the large lenders perceive the energy situation in the U.S., how energy considerations are factored into credit decisions, and what steps, if any, are being taken to encourage conservation among various borrowers. Additionally, an attempt was made to gauge their feelings regarding a possible federal role in influencing lenders to promote or encourage energy conservation in their lending activities.

Second, a review of relevant literature and federal regulations was undertaken in order to assess the current powers of the Federal Reserve Board and the Comptroller of Currency over Federal Reserve member banks and commercial banks with national charters (the former falling under the aegis of the Federal Reserve Board, and the latter

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under the Comptroller of the Currency). Background information on the use of "moral suasion" on the part of the Federal Reserve, the subject of credit policy and credit allocation, and various alternative banking methods and policy options, was collected and analyzed.

Third, the fundamentals of lending decisions were reviewed and analyzed in order to develop an understanding of the function of energy considerations in the loan process.

2.0 ANALYSIS

2.1 Approach

In the aggregate, \$242 billion in credit was provided by domestic private financial institutions in 1977. This was generated from various sources, one of the biggest being the private commercial banks (See Table 1.) Thus, by capitalizing on the fundamentals of the credit markets, i.e., the leverage factor associated with the transfer of funds from a lender to a borrower, and the lender's perceived influence on the borrower, is considerable.

This analysis considered two types of banks and their borrowers. One is the large money-center bank, which satisfies the financial needs of the "Fortune 500" borrowers, who are the largest consumers of energy, as identifiable units, on a day-to-day basis. The second is the city-wide or regional bank, which derives much of its business from local consumers. Differences between these two kinds of banking institutions and their client groups influence their approach toward energy-related issues.

2.2 Banking Community Motivation

An important factor in considering this issue is the motivation that lies behind a bank's interest in energy conservation. It is clear to many that conservation makes economic sense for borrowers and lenders alike. Not only can borrowers save money by conserving energy, but they also protect themselves against future energy price increases; i.e., conservation provides a "hedge" against inflation. The above considerations tend to have a

positive effect on borrowers' "bottom-line"; therefore, they become a better credit risk for the lenders.

There are additional reasons which might cause a bank to consider using an energy-conscious strategy in its operations, or promoting conservation among its customers. These reasons include the following:

- A business opportunity, or market demand is perceived for conservation-related activities. As energy costs rise, families and businesses are increasingly seeking ways to ameliorate the problem. Such measures may include retrofitting and the purchase of energy-efficient homes, cars, and appliances.
- Loan losses due to fuel prices or shortages, or to a lack of adaptability, may be reduced if banks recognize the role of energy considerations in the loan process.
- A conservation program, such as reduced interest rates for retrofit loans, may be used as a "loss leader" to attract other, more profitable business.
- Corporate social responsibility and good public relations are served by recognizing community needs and interests. Moral suasion as a public relations gesture rarely, however, outweighs profit as an initiating motive. Concern for the financial health of a city or community as a result of energy problems may be a factor, because it is desirable for banks to operate in financially stable conditions.
- Voluntary conservation-promoting measures may serve to forestall possible government regulations. Many banks are wary of what they perceive as government interference in free market activities, and would take steps to prevent federal intervention, even in the form of an "unofficial" position.
- The scope and importance of the energy problem requires a response from the banking community.

2.3 Banking Options

Various options exist, for banking institutions interested in the promotion of energy-conservation. One of the most common

methods which banks consider is that of preferential loan treatment in the form of special consideration or, more typically, interest rate reductions.

Interest rate reductions may be used at flat or variable rates, depending on bank preferences. These reductions would be made available for commercial or personal retrofitting projects, for the purchase of conservation devices, and for mortgages on energy-efficient homes. The variable rate is especially applicable to mortgages and purchases of such items as cars and boats, all of which may vary in the level of energy-efficiency obtained. One bank which has utilized this principle since 1976, the Seattle Trust and Savings Bank, uses a mortgage interest rate reduction scale which is based on conservation "points" such as storm windows, weather stripping, appropriate insulation, etc., which determine the energy-efficiency of the home.

While interest rate reductions are particularly promising and common techniques through which conservation is promoted, they fall short because they fail to consider the small, less-expensive conservation devices for which bank loans are rarely taken. Banks can, however, offer contractor lines of credit to installers of conservation devices, who could then make these devices more readily available or offer financing to their customers, in much the same way as auto dealers or furniture and appliance stores do.

A related measure is that of the integrated marketing project, whereby banks join with other parties, i.e., utilities, manufacturers, contractors, distributors, local governments, etc., to promote and deliver conservation products to the public.

Large group marketing, or financing through large corporations to their employees is another option. These corporations could participate in such a promotion through educational campaigns and payroll deduction plans.

Cooperation between several banks within a metropolitan region could establish an energy loan pool. The banks would contribute to this revolving loan pool in an agreed-upon ratio, thus sharing the risks and/or losses which may result from offering conservation loans at lower, less profitable rates. Similar loan pools have been successful in urban rehabilitation programs.

As individual institutions, banks could form "energy centers" as a focus for that particular bank's services in the energy area. This market ploy, particularly when employed in conjunction with other measures, serves to gain consumer attention in a less haphazard manner. Personnel in the energy center would be trained in energy issues and conservation methods.

A final suggestion which has been considered is the giving of gifts, premiums, or cash rebates to energy-conserving customers according to the type and amount of energy conservation measures taken. This could apply to borrowers who undertake conservation measures such as lowering thermostats, or changing fuel sources.

2.4 Money-Center Banks and Large Firms

As noted earlier, large corporations are the borrowers who consume large amounts of energy. Therefore, we closely examined the lender-borrower relationship as it applies to money-center banks and large firms. The indication is that although energy considerations are commanding increasing attention in lending decisions,

they are not considered a critical element. Lenders are primarily concerned with the underlying financial strengths of a borrower. A typical loan analysis will involve a review of the company's balance sheet, income statement, and the sources and uses section. These components will reflect a borrower's stability to repay a loan within a given timeframe, at a given interest rate. While external factors are always considered, current banking practice dictates that present and projected "cash flow" reflect a borrower's credit-worthiness.

Energy considerations tend to receive the most attention in those cases where the business of the borrower is energy intensive or the borrower has an obvious inability to change to an alternative source of energy. Locational considerations are also receiving increased attention. By and large, lenders are concerned with the availability and price of their borrower's fuel supplies. However, with respect to energy conservation, they view this as the responsibility of the borrowers. Lenders believe that borrowers are aware of increasing energy costs and have taken, and will continue to take, appropriate steps to reduce overall energy use in the interest of maintaining and enhancing profitability. Using less energy is a "bottom-line" consideration of which energy conservation is a byproduct.

Moreover, lenders do not feel that it would be appropriate to "dictate" a concern for energy conservation to their borrowers. Not only do they feel that borrowers are already taking significant steps in that direction, but also, the commercial lending market,

for the money center banks, is presently highly competitive; therefore, lenders are unwilling to put any type of pressure, outside the normal covenants and agreements, on borrowers. Standard banking practice dictates that the lender will not interfere with the borrower's operations unless the borrower is experiencing financial difficulties. Furthermore, commercial lenders are unlikely to give preferential treatment to borrowers for doing something, i.e. conserving energy, that is cost-effective and enhances the financial security of their operations.

In investigating the opinions of money-center bankers regarding a possible federal role in promoting conservation among corporations, it became apparent that any attempt by a federal agency to influence or intrude on private market credit decisions for specific energy policy goals is likely to meet with hostility and resistance from bankers as well as the federal regulatory bodies (e.g., Federal Reserve Board, Comptroller of the Currency). The underlying reasons are twofold. First, those commercial lenders interviewed believe that market forces should be left alone and that in finding various equilibriums, policy objectives will be achieved. Moreover, these bankers expressed a belief that government intervention in the private market tends to create a "hothouse" effect in which the social objectives depend for their survival on continued government intervention or support. Once this support is withdrawn, many of these objectives and their attendant federal programs cannot survive normal market forces, (e.g., Operation Breakthrough). Second, there would be resistance to intrusion on DOE's part into an area (banking

regulation) where the Department has little, if any, perceived expertise. The banking community feels that DOE should maintain a more restricted energy perspective and leave credit and banking policy to the Federal Reserve and the Treasury.

Likewise, lenders would regard the Chairman of the Federal Reserve or the Comptroller of the Currency taking a leading position in promoting energy conservation as being inappropriate. Lenders look upon these organizations as the keystone of domestic credit markets. Their perceived mandate is to protect the underlying strengths and stability of those markets and to ensure a smooth flow of funds through the banking system. Promoting energy conservation is thus outside their realm. As one commercial lender put it, "It would be the right message from the wrong people."

2.5 Regulatory Powers

Although the power of both the Federal Reserve Board and the Comptroller of the Currency are extensive, they are used primarily to ensure procedural regularity in bank lending practices. Our review of banking regulations indicate that these powers are used on a post hoc basis. That is, they are primarily used after loans have been made; little attention is paid to who should get financial credit.

The only exception to this is the Credit Control Act of 1969, Sections 205, 206. The Act gives the President broad powers to authorize the Federal Reserve Board "to regulate and control any or all extensions of credit." This power has been instituted "for the purpose of preventing or controlling inflation generated by the extension of credit in an excessive volume," but the powers specified in Section 206, Extent of Control, are broadly drawn and could

presumably be exercised to require certain types and quantities of lending in a specific area, such as energy conservation. This ultimate Presidential power has not been used to date, and is understood to pertain primarily to matters of acute and rapid inflation and national emergency. However, it is the clearest and the only direct authority by which any and all specific credit flows in the economy can be fully controlled or directed.

An assessment of the attitudes of the bankers interviewed indicates that even the appearance of an "unofficial" position taken by any of the various regulatory agencies would be viewed with skepticism and alarm by lenders. While such a position might be taken with the best of intentions, lenders would perceive this to be the forerunner of a new government regulatory program. Lenders view government regulations as all too often being unnecessary, burdensome, and costly.

"Unofficial" positions in credit policy have been taken in the past, however, with good results. For example, in 1974 the Chairman of the Federal Reserve Board sent an open letter to the presidents of each of the Federal Reserve member banks with overseas branches, in which he noted that large sums of dollars were finding their way into Eurodollar time deposits, where interest rates were roughly twice what was then available in the U.S. While the Chairman recognized that he had no regulatory power to stop the outflow, there was potential for "moral suasion" and successfully used it to accomplish his objective. The outflow quickly diminished.

Historically, there has been great political resistance to any attempts by the Federal Government to formally or informally direct the commercial credit markets. This resistance is strongest

within the banking community, but is also significant within the Congress and the banking regulatory agencies. Except under emergency conditions, there is a congruence of views that controls or credit allocation do not, in the long-run, achieve current social objectives.

Another factor of concern is that the banking community is well organized and represented in Washington, D.C. The American Bankers Association represents 93 percent of all the banks in the United States; their membership numbered 13,600 banks as of December 31, 1977. Thus, their potential political influence and ability to resist additional federal regulations is substantial.

It should be noted that while money-center banks are a major source of credit, particularly for large commercial borrowers, it represents only 32 percent of all credit provided in 1977. Moreover, there are characteristics of the commercial, or money-center, lending market which are unique to that financial sector. For example, as noted, most of the borrowers of the largest commercial banks are well-informed businessmen who are generally aware of conservation opportunities within their firms as well as their industry.

2.6 Smaller Banks & Insurance Companies

Relatively speaking, awareness of conservation potential may not exist among smaller corporate customers where loans would range from 100K to 1000K. There is some conjecture that relatively smaller banks have less sophisticated borrowers, who might thus benefit from a federal program which is directed toward the promotion of energy conservation by lenders. Valuable opportunities for

lenders to encourage energy conservation practices among their borrowers may, in fact, exist but may not be fully exploited.

In order to determine if this is the case, a survey of smaller regional banks was undertaken. It is in this part of the commercial credit market that federal initiatives may be appropriate.

Smaller banks are more capable of responding to and influencing consumers. However, even here, there are factors which may offset the various motives and methods for conservation promotion among small businesses and consumers. Before discussing these factors, it is important to note that short-term commercial lenders do not require consideration of energy issues as much as long-term lenders, who are more interested in the energy considerations involved in evaluating a project and its economic viability. Long-term lenders include both smaller banks and insurance companies.

Recommendations for action fall into three major categories; new services, such as advice on conservation investments; new applications of existing services, such as loan rate reductions; and new roles for banking institutions. The drawbacks which cause small banks to avoid these recommendations, and conservation issues in general, include the following:

- Banks see little return from conservation-promoting gestures. Some banks have reported that they have instituted conservation programs with little consumer response. Consumer interests are seen as protean, and not necessarily stable sources of profit.
- Banks are reluctant to get into issues and markets with which they are not familiar. Utilities, manufacturers

and distributors of conservation products and services have a direct and immediate vested interest in promoting energy conservation. Bankers feel that these groups should assume leadership roles in stimulating consumer demand in the conservation area.

- Competition among banks is marginal and incremental, and the economics of their operations limit their opportunities for radical improvement in the terms that they can offer consumers.
- Consumer demand for financing of energy conservation is derived, not primary. Consumers use bank services as a means to acquire some other good or service, and focus on the price involved rather than being sensitive to variations in financing terms. Also, certain conservation-related loans, such as home improvement loans are discretionary expenses and are not a necessity, as are mortgages, for most home buyers.
- Banks promote their product line (loans, "free" checking etc.) sometimes with emphasis on the goods or services for which their product line may be useful, but these are examples of the versatility of their services, and not endorsements for cars, vacations, etc. Indeed, banks have a limited ability to promote the primary item. Also, it is unlikely that banks would suggest that their customers are unwisely investing their money, that, for example, they should buy a Toyota instead of a Cadillac, or insulate their homes rather than go to Hawaii.

This present survey also included discussions with senior officials of two insurance companies. The terms of their loans are considerably longer than those of money-center banks. Insurance companies book 25-year loans, while a money-center bank will tend to make seven years the maximum maturity. The insurance companies may be more concerned, therefore, with energy considerations than are the money-center bankers.

Insurance companies are major sources of credit as well. In 1977 alone, insurance companies provided \$29.2 billion to the credit markets. The bulk of these monies went to "private placements" of debt instruments such as corporate bonds and debentures. A significant portion of the funds go to finance large commercial or industrial projects or real estate ventures. Here again, the potential for energy conservation appears considerable.

3.0 URBAN PROGRAMS

There well may be a federal role in promoting energy conservation through both the regional banks as well as through insurance companies. In both cases, the fundamentals of lending/borrowing relationships exist, i.e., the lender has a certain leverage over the borrower.

Two questions have not been addressed thus far in the analysis:

- How can banks and cities work together to alleviate urban energy conservation problems?
- What role can the Federal government, particularly the Department of Energy, take in promoting energy conservation through banks and cities?

One well-publicized example of the involvement of cities is the Seattle program. In 1976, Seattle passed a City of Seattle Resolution "adopting energy conservation policies for the City of Seattle and setting forth a schedule for implementing them."¹ The Seattle Trust and Savings Bank's program, a substantial conservation effort, was initiated in the same month as the city Resolution. The Bank's program was designed by a team of independent energy consultants working with bank personnel and advertising professionals. However, the motivation was that of a demonstrated probability of a market demand for the program.

The Seattle Trust and Savings Bank's conservation measures included these benefits:

¹ENERGY AND THE CITY, Hearings before the Subcommittee on the City of the Committee on Banking, Finance and Urban Affairs, House of Representatives, Sept. 14-16, 1977.

- Improved lending rates on an energy conservation point system for new and old home mortgages.
- Improved loan rates for customers who agree to use some of the borrowed funds for conservation purposes.

The measures taken by the City of Seattle, which are complemented by the above bank actions, include these:

- Establishment of 13 educational and consumer information programs focusing on weatherization, insulation, installation of conservation devices, conservation audits, and energy conservation seminars for commerce and industry.
- Establishment of an office of conservation to manage Seattle City Light's electrical energy conservation programs.
- Establishment of a city energy office with a staff working full time on overall energy conservation planning and program development.
- A commitment to revise structure-related codes to promote conservation. Also, implementation of heat-loss standards for new homes.
- Energy-efficient home certification provides recognition for particularly energy-efficient new homes.
- Establishment of seven energy conservation research and development programs. These are examining ways of using energy rates to encourage conservation and are following conservation trends throughout the nation.

- Establishment of municipal energy conservation programs, such as installing a heat pump system in the Seattle City Light building, etc.
- Low-income elderly weatherization: inspection of the homes of the low-income elderly and arrangement for necessary weatherization.

The range of municipal tools which can be used to facilitate market penetration of conservation measures in residential and commercial buildings is large and varied. Tax credits for conservation measures and loan guarantees are two methods. Others include the forgiveness of additional real estate taxes which may deter home owners from improving the energy-efficiency of their homes; adoption of building standards relating to efficient design; conservation related job-training and public works jobs on city and non-profit buildings; and promotion of municipal cooperation with utilities.

In the area of retrofitting, middle and lower-middle class populations find a major obstacle in that capital is not readily accessible for these purposes. Cities will probably have to exercise their influence to encourage utilities and lending institutions to finance home and building retrofits. Municipalities could promote financial pooling arrangements among local banks, which would have specific criteria for making such retrofit loans. A city could also provide energy conservation loan guarantees by backing the bank loans or providing funds directly through a municipal bond issue.

In addition, both banks and cities should recognize the fact that some homeowners find it necessary to concern themselves primarily with paying for home heating costs, putting a further drain on funds

that might be available for retrofitting which would cut heating costs in the long run. Banks, therefore, with the assistance of cities, should investigate the possibility of bill-paying loans for emergency situations; i.e., fuel-oil shortages, drastic price increases, or severe weather, perhaps in combination with a loan for retrofitting. Another possibility is that of promoting trust funds, or savings accounts, designed to save for retrofitting or to put aside money in anticipation of drastic increases in fuel costs.

Municipalities may also need to reconsider tax codes and other institutional devices which contribute to sprawling, decentralized, energy-inefficient development patterns and which favor investment in new commercial, industrial and residential buildings over the repair and maintenance of older structures and facilities.

Cities, however, will not be able to provide direct financing to conservation efforts at a significant level. Financing will have to be provided by local lending institutions or utilities, or a combination of the two. Thus, the role of municipalities is to promote cooperation between the potential sources of funding for a conservation program aimed primarily at low-income urban residents. This could involve establishing special financing arrangements and passing legislation exempting them from current ordinances.

"There are several energy conservation measures where local governments must rely on aid and assistance from other governmental jurisdictions in order to implement conserving programs. For example ... local government needs federal

assistance in determining accurate trend information on what cities, as consumers, will be competing. To secure this information, cities may rely on the new U.S. Department of Energy, their state energy office, or on national and state level municipal organizations (e.g., The National League of Cities and the U.S. Conference of Mayors).

"Cities may also require technical assistance/transfer (e.g., HUD's three capacity-building programs) in collecting and assessing the data at the local level in order to give a clear direction to local needs and provide a clear guide in setting local priorities.

"Third, cities may need financial assistance in taking corrective actions; such as tax incentive legislation for conservation measures taken by citizens, grants-in-aid for developing alternative energy sources or for retrofitting government buildings, or for increasing efficiency of existing systems across a broad scope of possible projects."¹

¹ Energy and the City p. 106

4.0 CONCLUSIONS AND RECOMMENDATIONS

The analysis and background work has led to a number of conclusions:

- Financial barriers have hampered widespread conservation efforts (e.g., lack of available funds for individuals in conservation).
- Banks are recognizing, slowly, the importance of energy considerations in credit analysis, although this recognition does not primarily apply to short-term commercial loans. Recognition of energy problems has, in some cases, altered or added to existing bank policy.
- Commercial lenders and regulatory bodies would resist any attempt by DOE to intrude in private market credit decisions for the accomplishment of specific social goals.
- A voluntary program of promoting energy conservation by commercial lending institutions, urged by DOE and promoted through federal banking regulators, would be politically sensitive, costly to undertake, and administratively demanding to continue in a meaningful way.
- A voluntary program would require a substantial effort for uncertain, if not immeasurable, results. Also, it would be difficult to demonstrate that such a program would materially affect current or future energy consumption by commercial borrowers.

- Banks need to be informed of energy problems and issues and of the market possibilities involved in conservation efforts. (DOE could be of use in this area.)
- Local governments, especially cities, are in an excellent position to promote voluntary energy conservation efforts in the community and to assist homeowners and businesses in the community to take advantage of available tax credits.
- In as much as local banks are involved in the financial welfare and routine of the community in which they exist, they will naturally be drawn into the prevailing stream where strong community and municipal or regional conservation efforts exist.
- If financial institutions are to become substantially and successfully involved in conservation efforts, it is essential that they cooperate with municipal and local governments as well as professional energy consultants and utilities.

The following recommendations apply to a possible DOE role in promoting energy conservation through banks and cities:

- Since banks act as respondents to consumer demands, it is up to DOE, cities, and consumers to generate and to demonstrate a demand, or profitable market, for an active banking role in conservation efforts.
- DOE should encourage community efforts at conservation, lending advice where necessary, and legitimizing plans

for community conservation measures (such as solar collectors, wind power, retrofitting, shuttle systems, etc.) which, in turn, may make it easier for local banks to finance the projects.

- DOE should make information available to banks and their customers on how to prepare homes to be energy-efficient and on the energy matters that concern these groups, i.e., conservation devices, installation, insulation, energy-efficient appliances, etc.
- DOE should provide technical assistance teams, where appropriate, to local governments, and should support projects to find answers to specific questions relating urban form and density to energy use.
- Technical assistance teams can both involve local officials in national energy programs and respond to the energy related needs articulated by local governments.
- Funding for conservation and energy planning.

Any Federal role based on these conclusions should take into account the impact of banks on communities and the impact of government on banks.

The following are some possible federal funding sources which have been suggested as means for supporting conservation programs:

- An excess profits tax
- Increased taxes on gasoline
- Increased taxes on inefficient automobiles
- Diversion of federal money and private capital for nuclear reactors

- Revenues from abolition of depletion allowances.

It has been recommended that the formula for the distribution of such monies could be tied to state and local energy conservation programs, e.g., implementation of building, housing, plumbing and mechanical codes which are energy efficient. It has been further suggested that revenues from the energy programs be redistributed into other energy-related programs, such as mass transit, conversion to coal, and conservation programs promoted by cities and individuals.¹ Also, the federal government should emphasize steps it is taking to ensure a strong role for local governments in implementing energy conservation programs through the creation and funding of city-directed programs.

¹ENERGY AND THE CITY, p. 295

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LAWS

1. Federal Reserve Act, as Amended through 1976
2. National Currency Act
3. National Banking Laws, Regulations and Interpretive Rulings
4. Credit Control Act of 1969
5. Various Commercial Credit Laws
6. Other laws with credit provisions; for example, those dealing with the housing industry and its financial markets (Housing and Community Development Act, Community Reinvestment Act, etc.)