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IS NET ZERO REALLY A HERO?



a wipro company

ACHIEVING NET ZERO EMISSIONS: DELINKING THE CHALLENGES ACROSS KEY UK FINANCIAL SECTORS

In September this year, climate change group Insulate Britain temporarily blocked the Port of Dover, Europe's busiest trucking port. This followed other protests over a two-week period in August and September aimed at pressuring the UK Government into providing insulation for 29 million homes in a bid to curb fossil fuel use and fight global warming. On November 6, a planned Global Day for Climate Justice will see demonstrations across the world demanding decisive action from the United Nations as it holds its crucial COP26 climate change conference in Glasgow, Scotland.

This escalating level of public concern is mirrored in the recent Intergovernmental Panel on Climate Change (IPCC) report that states a failure to limit global warming to 1.5°C will result in serious disruption:

floods and fires will become ever more frequent and fiercer, crops will be more likely to fail and sea levels will rise, driving unprecedented mass migration. Above 1.5°C, there is real risk of triggering climatic tipping points – such as the melting of arctic permafrost, releasing millennia of stored greenhouse gases – that are expected to precipitate an irreversible and catastrophic shift in the world's climate.

With COP26 set to begin at the end of October, the UK government needed to be seen to act. UK Prime Minister Boris Johnson accordingly announced a package of 18 deals worth £9.7 billion that are intended to support green growth and create an estimated 30,000 jobs across various sectors.



Employment

By **2030**, a projected **440,000** additional jobs will be created

With **190,000** of these jobs being created by **2025**



Investment

18 deal package, worth **£9.7bn**

mobilisation of **£26bn** of capital investment mobilised for the "Green Industrial Revolution"

£620m promised for EV rollout



Environment

10-20% reduction in vehicle emissions

20 to 30 mtCO₂ of carbon capture capacity created

Treble woodland creation rates in the UK

While the proposals are broadly in line with expectations – the replacement of polluting gas boilers, support for the switch to electric cars being prominent among the initiatives – many observers across the scientific and political spectrums have criticized the proposals as over-cautious. In addition, a separate report on the cost of net zero released by the UK's HM Treasury warned that the transition from fossil fuels will require new sources of taxation to replace the £37bn lost from petrol taxes, negatively impacting household incomes. The report also noted that government intervention will be required to ensure a fair transition for low-income households.

This latest Government package comes in the wake of a promised £26 billion in capital investment to spark a "green industrial revolution".

The Government maintains this will support up to 190,000 jobs by 2025 and up to 440,000 jobs by 2030, and also leverage up to £90 billion of private investment by 2030. Proposals include producing all electricity from clean sources by 2035; ending the sale of new petrol and diesel cars by 2030 and new gas boilers by 2035; meeting energy efficiency targets on mortgage providers' portfolios; and making the UK a world-leader in zero-emission flights.

In this short paper, we discuss some of the key challenges that lie ahead, and the sectors which will be adversely impacted going forward – resulting in a trickle-down effect that will be felt by the UK public at the household and individual level.

NET ZERO: FINANCIAL SERVICES-RELATED IMPLICATIONS

BANKS, INSURERS & ASSET MANAGERS

If the UK Government proceeds in mandating that financial services institutions must adhere to specific energy performance targets within their portfolios, then those companies' ability to offer **mortgages** could diminish significantly. Given the current state of the UK's housing stock – with 68% of homes currently below target (EPC-rated D or below) – this could have profound ramifications.

With the ability to secure mortgages for such homes constrained, homeowners may see a fall the value of their properties, giving rise to possible credit risk concerns with lenders observing worsening loan-to-value ratios. A subsequent growth in transition finance is then likely, as homeowners – if initially reluctant – are drawn into committing significant sums towards home energy improvements as they seek to avoid their properties being accorded junk status in an emerging two-tiered mortgage market.

Assessed from a capital markets perspective, **asset managers** will face immense pressure from investors and activists to divest from (often profitable) fossil fuel industries. Particularly in the midst of a commodity price boom – as demand from post-pandemic recovery programmes boosts demand for energy and resources – asset managers will be conflicted as they seek to balance green credentials with a mean performance.

Insurance companies have thus far focused on diverting investment portfolios away from polluting companies. They too, however, are facing growing pressure from policymakers and investors to reduce their 'insured emissions' – that is, the carbon footprint of companies to whom they provide cover. By extending this green filter from just their investments to also excluding potential underwriting revenue, they risk eliminating a sizeable chunk of renewal business. Notably, Swiss Re announced in March 2021 that it would start to phase out coal from insurance policies that it reinsures as of 2023. This looks set to play into the hands of competitors, with reinsurers from India, China and Russia more than happy to take on new business despite a lack of green credentials.

THE ELECTRIC VEHICLE MARKET

The proposed transition to electric vehicles (EVs) outlined in the UK Government's 'Net Zero Strategy' will have a profound impact upon various segments of the financial sector. **Auto insurers** will have to navigate new forms of risk and increasing claims complexity. Whilst EVs have fewer moving parts compared to their internal combustion engine (ICE) counterparts, these parts are more deeply integrated; the days of popping to the local garage may be numbered.

Notably, components now communicate digitally via a layer of software, leading to new questions about liability – who is in control and accordingly where does ultimate responsibility lie in the event of an accident. This heavier reliance on software also brings an increased cyber risk from glitches, outages and malicious attacks.

The use of batteries is another prime source of new risk scenarios. Lithium-ion batteries may combust when damaged or overcharged, and electrical fires can be difficult to extinguish. The insurance implications of a scenario where an overcharged vehicle in a busy parking lot causes a large destructive blaze are sobering.

On the face of it, things also look tough for **finance providers**. Currently, one-third of consumers cannot afford even the cheapest EV offering, reinforcing negative consumer perceptions surrounding this nascent auto sector. Furthermore, consumer anxieties relating to the range and charging of such vehicles persist. When compounded with the steady shift towards subscription-based vehicle ownership (which need an inherent amount of flexibility in fueling to deliver the shared utility, hence more suited to traditional or hybrid cars), this may lead to suppressed EV demand and a reduction in the size of the financing market, even as regulations change to promote the sale of EVs.

However, with 90% of new cars being purchased through finance, and the relative price of EVs falling rapidly – both from UK Government grants (which offer up to £2,500 towards eligible near-zero emissions vehicles) and the expansion of supply – EVs could become a valuable opportunity for players in the auto financing space. However, for an efficient financing marketplace to prosper, longevity, residuals and repair costs all need to be better understood.

UK ENERGY CONSUMERS

With UK gas prices currently soaring, the prospect of electric heating systems may seem attractive, although in the long run domestic fuel prices typically even out over time (arbitrage pricing). However, to ensure energy efficiency, costly insulation and other home improvements will invariably be required – and in the future, home improvement loans may become a key component of such upgrades. While initial sunk costs are incurred, the homeowner can reap the benefits of cheaper electric heating sources in the years to come.

Besides advising the installation of a new heat pump on the side of your house, the new Net Zero regulation may affect your access to finance, tax rates and potentially the value of your property due to un-intentioned micro-economic factors influenced by these new proposals. Although these impacts may be cause for concern, in these days of 'conscious consumers' the push to implement environmentally-focused regulation is welcomed by many.

MORTGAGES AND LENDERS

In the following precis, we assess the influence of the expanding 'green' mortgage market, potential tax rises enforced by the 'polluter pays' principle, and the actual costs consumers may incur in an emerging eco-economy.

The UK Government is seeking to develop a **green housing stock** via regulation in the form of Energy Performance Certificates (EPC). It is expected that mortgage lenders will have to disclose the EPC ratings of their properties, making it difficult for owners of energy-inefficient houses to access finance.

Lenders are incentivised to grow the number of green homes on their books by targeting an average EPC rating of band C by 2030. However the borrower, without sufficient funds to improve the energy efficiency of their property, may struggle to remortgage. Should they then sell the property? Not so fast – owners of inefficient properties will likely struggle to find buyers as cheaper mortgages will become more and more difficult to find – IFAs and mortgage brokers will accordingly have their work cut out.

Ultimately this uncertainty around mortgage funding may see the emergence of a tiered or multi-layered liquidity market. We can expect a division between the haves and the have-nots – the former in cosy

(C and below) properties, the latter in draughty (uninsulated EPC D and above) houses – and an attendant (price) bifurcation of the UK housing market.

If disparities in access to finance and the ability to make energy efficient home improvements do lead to a two-tiered consumer market, the recent example of UK stamp duty changes suggests market forces will eventually drive a normalization of prices over time; as all additional costs are priced into the market – although not without cost to the consumer in the interim. There may be scope for future regulation or policy adjustments to factor in lending affordability criteria and so ensure there is a suitable buffer available. However, the current financial view looks bleak from the average Englishman's home (which ideally now shouldn't possess the heating and insulation shortcomings of a castle).

How, then, is the UK Government funding the push to the sunlit uplands of this greener future? It professes to be following a 'polluter pays' principle, whereby potential increases in 'transition taxes' are used to stimulate change. In reality, these proposals are more of a stimulus carrot than a pure fiscal stick, and don't seem to spread the burden across society on a pro-rata basis to pollution creation.

In side-stepping government borrowing, costs are not passed onto future taxpayers. However, using an individual's tax contribution for funding is unlikely to sit well with the public given the significant role of large corporations in driving carbon generation. Future corporate tax developments could be used to ease such tensions, but for now the burden sits squarely with the UK electorate.

The 'green industrial revolution' will not only influence how homes are heated and powered, it also aims to stimulate the economy through 30,000 new jobs. The creation of these jobs across a range of industries is pitched as encouraging an environmental focus and direct investment to facilitate a greener future. However, industries that are unable to adapt may see a decline in activity. Whether it is a drop in traditional fossil fuel dependent sectors, like local car garages, or high transition costs that don't allow additional staff hires, the net job creation could prove less than anticipated. What can be assumed however is that the influx of grants from the Net Zero financing scheme will aid the transition of productivity towards low-carbon activities and outputs. Prices of carbon-intensive consumer goods are likely to be driven up (by both supply and demand side factors), with ramifications for the wallets of the UK public.

CONCLUSION

Whilst it is positive that the UK Government has set these green initiatives in motion, the unintended consequences need to be clearly identified, measured and managed by financial services providers.

A deleterious effect on the loan-to-value ratio of cars and homes; bifurcated secondary asset markets; the fragmentation of funding models: all are potential outcomes of a policy approach that may or may not achieve its green ambitions. What is clearer is the impact on consumers via the financial products that both support and drive growth in these areas.

Media reports suggest tensions between No 10 and No 11 Downing Street, with the Prime Minister's ambitious climate goals running up against a pragmatic Chancellor gloomily surveying the taxation implications of those aspirations. It remains to be seen who will win out in the long run – whether politically, in the eyes of consumers, or in the context of UK industry, including financial services.

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