Finance Watch

Tackling financial risks related to the fossil fuel financing of US banks

October 2022

$1.35 trillion of fossil exposures with underpriced risks

Banking supervisors are increasingly concerned about the links between climate change and financial stability. Bank financing of the fossil fuel sector is at the heart of the issue, as fossil fuels are the main contributors to accelerating climate change and many of the assets associated with the fossil fuel industry will need to be abandoned before the end of their economic life (stranded) to achieve the transition to a carbon-neutral economy.

Finance Watch estimates that the 60 largest global banks have around **$1.35 trillion** of credit exposures to fossil fuel assets on their balance sheets. This huge sum is more than the amount of banks' sub-prime assets just before the global financial crisis and supervisors admit that the risks of today's fossil fuel exposures are not yet fully reflected in bank capital rules. This puts the banks solvency and financial stability at risk when climate-related risks increasingly materialise.

The most coherent and effective way to address this would be through a technical measure now being explored by legislators in the EU and Canada – adjusting capital requirements to recognise higher risks associated with fossil fuel financing. This requires the application of a:

150% sectoral risk weight to banks' exposures to existing fossil fuel assets.

To implement this, banks would need some additional capital. A new study from Finance Watch has looked at the impact of the 150%-risk weight proposal on banks and concludes that it would be feasible to implement without impacting bank lending capacity.

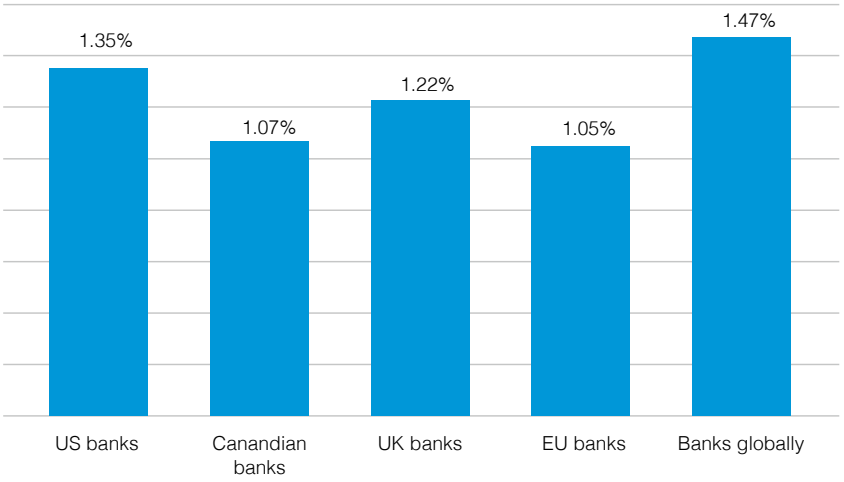
Additional capital needed globally and in the US

The study looks at the 60 largest global banks, of which six are based in the US. We find that on average applying a 150% risk weight to banks' exposures to existing fossil fuel assets would require additional capital equivalent to around 3-5 months of banks' 2021 profits on average.

The average additional capital per bank would be $3.06 billion, equivalent to 2.85% of the banks' current equity (as of 31 December 2021) or 3.42 months of their 2021 net income.

The six US banks in our sample – JPMorgan Chase, Bank of America ML, Citigroup, Wells Fargo, Morgan Stanley, and Goldman Sachs – have a similar level of exposure to fossil fuels as the global average. Between them, these US banks have $186.8 billion of fossil fuel assets on their balance sheets, which is 1.35% of their total assets, compared with 1.05% on average in the EU and a global average of 1.47%.

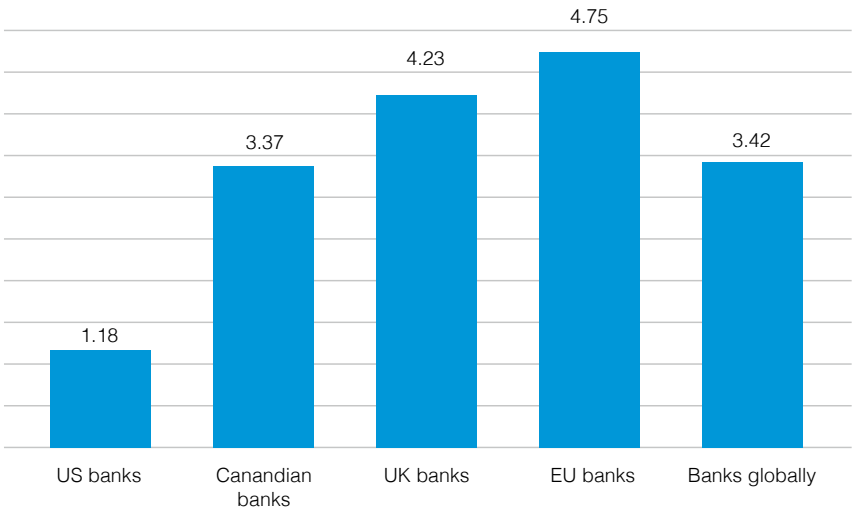
Fossil fuel assets / total assets



Despite these six US banks having larger balance sheets than most banks in the sample, we estimate that they would on average each need to raise only $2.63 billion in additional capital to apply a higher risk treatment to their fossil fuel assets, compared with the global average of $3.06 billion. This reflects the USA's more conservative regulatory approach to banks' credit exposures than other jurisdictions, as the current minimum required capital levels in the US are higher.

If the amount was raised by retaining profits, we estimate that these US banks could cover the combined additional capital with 1.18 months of their combined 2021 net income, compared with an average of 3.4 months for all banks in the sample. The comparatively low number of months to bridge the capital shortfall is explained by the higher profitability of the US banks in our sample in 2021.

Months to cover from profits



Implications for lending

In the years after the global financial crisis, banks raised a large amount of capital over 18-24 months without reducing their lending or total assets, by using a combination of retained profits and higher lending spreads.

The extra capital for this proposal is far smaller and for US banks is equivalent to retaining just a few weeks profits, although in practice banks would have longer to respond because such measures are normally phased in over longer periods.

With a suitable transition period, the new capital gap could be very feasibly bridged by retaining profits, without any reduction in lending capacity, which is important for supporting a sustainable transition.

It would not stop banks from lending to fossil fuel clients, although banks would have to include a higher risk premium in their fossil fuel lending.

Conclusion

Supervisors should work with banks to introduce a sectoral risk weight for fossil fuel exposures over a suitable timeframe. This would help to protect US banks from climate-related risks associated with financing of fossil fuel industry and disruptions due to accelerating climate change, without reducing their capacity to lend.

Download the full report here (in English).

For more information, please contact Finance Watch at *contact@finance-watch.org*.