Frequently Asked Questions (FAQ) - Fossil assets: the new subprimes?

During the review and dissemination of the report *Fossil Assets: The New Subprimes? How funding the climate crisis can lead to a financial crisis*, several questions emerged. This document provides concise answers to these questions to help understand the report, its methodology and its implications.

How where « fossil assets » defined and quantified?

For the purposes of this report, "fossil assets" are defined as assets that contribute to the financing of exploration, exploitation, distribution - including transportation, refining, etc. - of oil, gas and coal, and the production of electricity from these sources.

The financial data for "fossil assets" are taken from the balance sheets published in the annual reports of the banks studied. The identification of "fossil assets" in the balance sheets is based primarily on the categories and information that are published by the banks themselves. The varying degree of accuracy of this information and the opacity of some banks mandates the adoption of assumptions. More precisely, the identification of fossil assets in the balance sheets was done by looking at:

- The breakdown of risks by sector, which makes it possible to identify the sectors in which there are assets linked to coal, oil and gas (notably "Oil & Gas", "Energy" or "Utilities"). For sectors whose activities are entirely related to these energies, all assets held are accounted for. For other sectors, any specific information published by the bank and - without such information - allocation keys based on the share of fossil fuels in the sector are used.
- The fossil share of investment activities reported by banks or, in the absence of this element, an allocation key based on the share of these activities in European index and bonds.

Note that fossil assets held through asset management are only marginally included in the scope of this study. Indeed, only certain assets held on bank-guaranteed products appear on the balance sheets published by banks. This scope is consistent insofar as the risks associated with unsecured sub-managed assets are ultimately borne by their owner and not the asset manager.

In addition, certain types of assets have been excluded from the scope of the study or are subject to a specific treatment:

- Assets denominated in "Cash and Central Bank" have not been included because of their very low maturity, which makes them less exposed to climate risks.
- The amount of Repurchase Agreements (REPO) - contracts that allow financial securities to be lent/borrowed in exchange for monetary collateral - have been greatly reduced in order to take into account the very high presence of government bonds.

Several important elements follow from these methodological clarifications:

1. The following are not included in the scope of "fossil assets" accounted for:
    - All activities indirectly related to fossil fuels (e.g., automotive or aviation).
    - The imprecision of the information published by the banks concerning fossil assets may lead to their underestimation, particularly when the activities depend on the exploitation of these energies but are not classified by the banks in sectors that allow this link to be clearly established.
2. Estimates are based on different assumptions that depend on the degree of precision of the information published by the banks and on the feedback they have provided during the writing of this report.

Globally, and in particular because of the methodological choices made and the limited transparency of the banks, the scope used for "fossil assets" is conservative and limited. Climate risks affect many other activities dependent on fossil fuels that are not included in this report, hence the risk of a snowball effect.

The methodology was developed with feedback from numerous reviewers in the financial sector, including Carbone4 Finance. The banks were all consulted and several of them provided information to clarify the data in the report.

Is there a real risk of bankruptcy and/or crisis?

As the report makes clear, a significant loss in the value of fossil assets could significantly affect the equity of the banks studied. For some of the banks whose fossil asset holdings exceeded their equity, the consequences would be particularly severe.

However, as the report reminds us, several precautions must be taken before talking about the risk of bankruptcy:

- The fall in the value of fossil assets will most likely be gradual. It should be spread out over several years and affect the most polluting activities first - notably coal and unconventional hydrocarbons. Banks therefore have potentially enough time to react and adapt.
- The study focuses on the banks' Common Equity Tier 1 - reserves on the banks' balance sheet that allow them to absorb a decline in asset value - but the banks could mobilize other equity to absorb the decline in value of their assets. In addition, the banks studied have insurance policies that would allow them to cover at least part of the losses. In addition, the regulators could also intervene to allow them to access more capital.

These elements have not been taken into account in the scope of this study insofar as it specifically aims to identify how banks and financial regulation integrate - or fail to integrate - the specific risks linked to holding fossil fuel assets. The aim is to make banks responsible for the holding of their assets, and not to gamble on a possible deferral or dilution of the related financial loss.

This report therefore highlights the lack of preparation of banks for the significant financial risks of fossil fuel assets, but does not allow us to speak of a risk of bankruptcy. Of course, many assets not taken into account in the scope of the study could also be affected and considerably increase the losses for the banks with - in the long run - higher risks.

Looking at France, why are the results different from the ones of the ACPR and AMF's pilot exercise?

The two exercises are fundamentally different.

The ACPR and AMF analysis is based on climate scenarios and does not focus on fossil fuel activities. The scenarios used by the AMF and the ACPR are incomplete and optimistic. The dynamic balance sheet assumption adopted allows banks to gradually adjust their activities.

This is not the case in this report, which merely identifies fossil fuel assets in banks' balance sheets and highlights the risk of seeing them lose a significant part of their value. The scope of "sensitive activities" used by the regulators is not the same as that of this report, and the regulators do not take into account the stranded assets hypothesis that is at the heart of this report. However, like many other works and studies, and despite its limitations, the analysis of the AMF and the ACPR clearly highlights the concentration of risks in certain activities - notably coking and refining.

Recent events, and in particular the publication of the first IEA 1.5°C scenario, reinforce the various elements of the report which show the probability of significant losses in the value of fossil assets.

Is the “fossil bank” proposal a gift to banks paid for by the citizens?

In the current situation, an abrupt ecological transition could potentially lead to bankruptcies that would have major repercussions on populations and on the entire economic system, possibly even slowing down the ecological transition. Above all, the current overexposure of financial institutions to fossil assets may lead them to seek to delay the transition in order to keep their oil rents as long as possible and to preserve the value of their assets. Finally, the billions invested in fossil fuels are resources that cannot be mobilized to finance the transition.

In this context, repurchasing the fossil fuel assets of banks could contribute to the fight against climate change while reinforcing the stability of the financial system. The assets bought should then allow for a gradual exit from fossil fuels, in a just transition logic.

Of course, we do not propose creating a "fossil bank" that would "pay" for the banks' misadventures in fossil fuels without conditions and using the money of the citizens. The report sets strict conditions for the takeover of fossil fuel assets to ensure that banks do not continue to finance the development of these energies. The takeover would not concern all the assets and would be done with a discount, a way to make the banks responsible and to avoid windfall effects. The proposed "fossil bank" is a “bad bank” funded by the ECB. Because of the specificities of the central bank, this intervention avoids the use of public funds and thus ultimately of the money of European citizens.