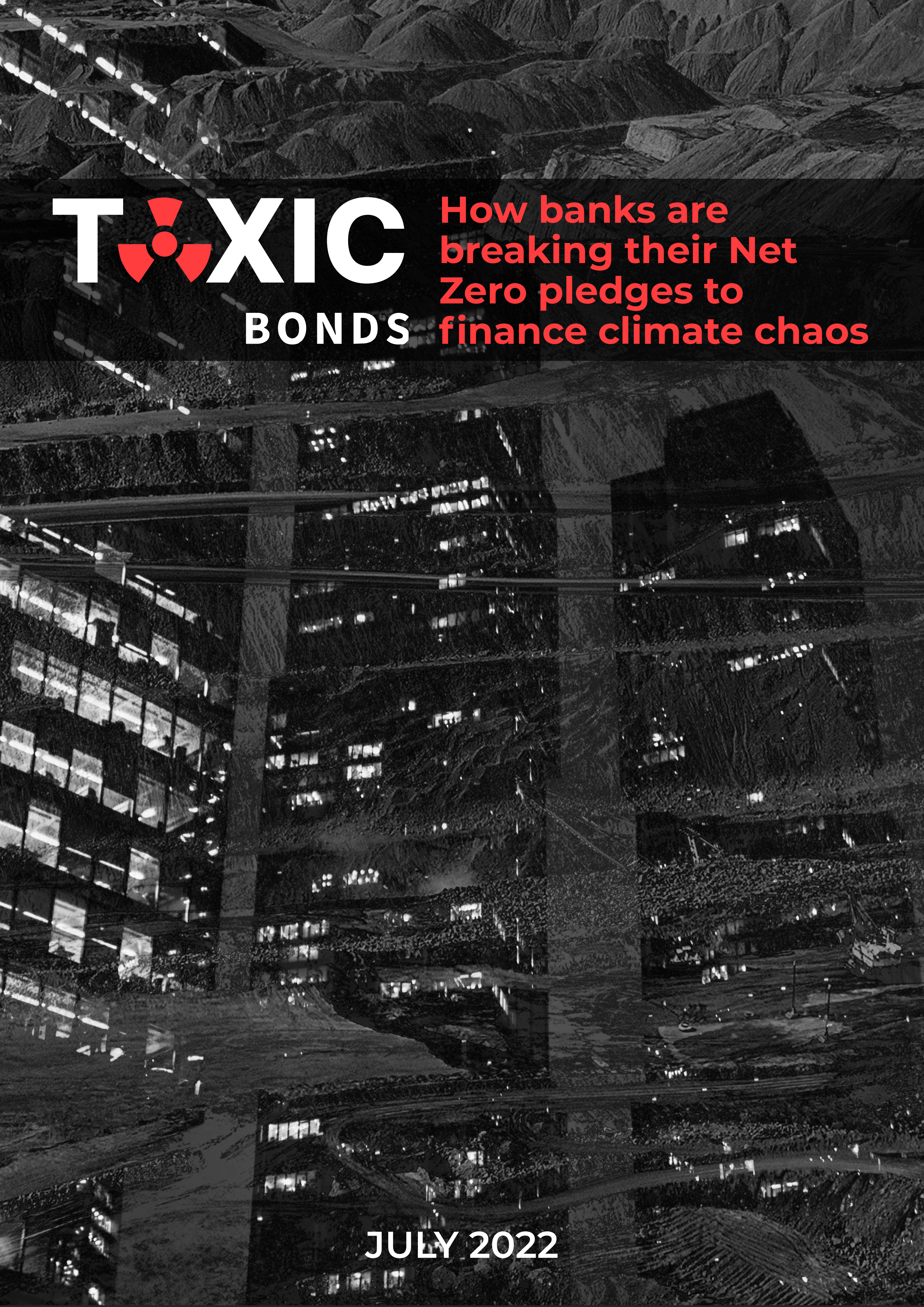

TOXIC BONDS

How banks are breaking their Net Zero pledges to finance climate chaos

JULY 2022

The Toxic Bonds Initiative brings together advocates to help draw attention to the role the bond market plays in fuelling the climate crisis and to help all market players transition their businesses away from climate destructive investments.

toxicbonds.org

Bank On Our Future is a network of international organisations and social movements working together to secure a climate-safe future for everyone. The network is committed to pressuring the biggest banks to align their business practices with a fair and habitable future.

bankonourfuture.org

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Contents

Introduction

To avoid catastrophic climate change, the International Energy Agency has made it clear: no new investments in fossil fuels. With the effects of the climate crisis gathering pace, there is mounting pressure for industries to act – including the banking sector, where many of the world's top banks have already made Net Zero pledges and are restricting lending to carbon intensive industries.

However, as the world attempts to undo the damage caused by fossil fuels; coal, oil and gas companies are using the bond market to finance expansion under the radar.

The bond market, where companies can borrow money from investors by selling debt assets, has become a safe haven for the fossil fuel industry. By issuing bonds, these companies enjoy less public scrutiny, less transparency and access to trillions of dollars of debt. These 'toxic bonds' enable them to get around lending restrictions and expand coal, oil and gas projects.

Despite climate initiatives like the Net-Zero Banking Alliance, banks play a vital role in facilitating this process. Acting as underwriters, they advise companies issuing bonds and help market the bonds to investors. Fossil fuel companies rely on banks' credibility and access to potential investors, casting serious doubts on the legitimacy of banks' green pledges and undermining the very credibility that fossil fuel companies seek to exploit.

In this briefing, we determine exactly how much money has been raised from toxic bonds by coal companies and those with the biggest oil and gas expansion plans since 2016, exposing which banks play the biggest role in facilitating this process and the money they make doing it. The key findings of this research are summarised overleaf.

> ***The bond market has become a safe haven for the fossil fuel industry, where companies can enjoy less public scrutiny, less transparency and access to trillions of dollars of debt***

Photo: According to The World Weather Attribution (WWA) initiative, Australian bushfires are made 30% more likely by climate change.[1] Credit: Ash Logan.

Key findings

- Since January 2016, banks underwrote bonds totalling US$2.7 trillion for coal companies and companies leading oil and gas expansion. US$2 trillion went to companies on the Global Coal Exit List[2] (GCEL) whilst US$700 billion went to the top 50 companies expanding oil and gas production.[3]

- US$926 billion – nearly a trillion dollars – of those bonds were arranged for the "Dirty 30" companies, identified by the Toxic Bond Initiative as among the top corporations using or planning to use the bond market to obtain finance to expand coal, oil and gas operations.[4]

- Banks generated an estimated US$8.6 billion in underwriting fees from these transactions, of which US$5.9 billion related to coal companies and US$2.7 billion to oil and gas.

- Two American banks are most involved in fossil fuel bond transactions. Since 2016 JPMorgan Chase arranged $103 billion and Citigroup arranged $99 billion. This is followed by the Industrial and Commercial Bank of China (ICBC) that arranged $95 billion in bonds for fossil fuels.

- However, three American banks earned the highest fees from these transactions: JPMorgan Chase (US$492 million), Citigroup (US$473 million) and Bank of America (US$425 million), followed by British bank Barclays (US$308 million) and Japanese bank Mitsubishi UFJ Financial (US$273 million).

- Despite climate initiatives such as the Net Zero Banking Alliance, many existing climate and fossil fuel policies and targets provide loopholes, either by excluding underwriting or only applying to new clients. This allows toxic bonds to slip through the net. To be credible, banks must include underwriting bonds and shares in addition to lending in all climate policies and financed emissions reduction targets.

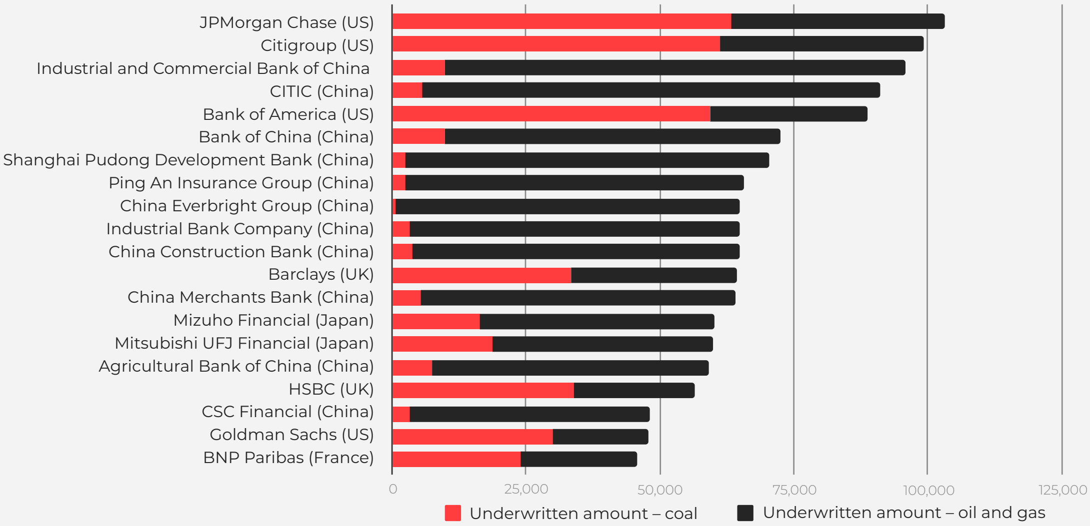


Figure 1: Top underwriters of fossil fuel bond issuances
(2016-2022, US$ mln)

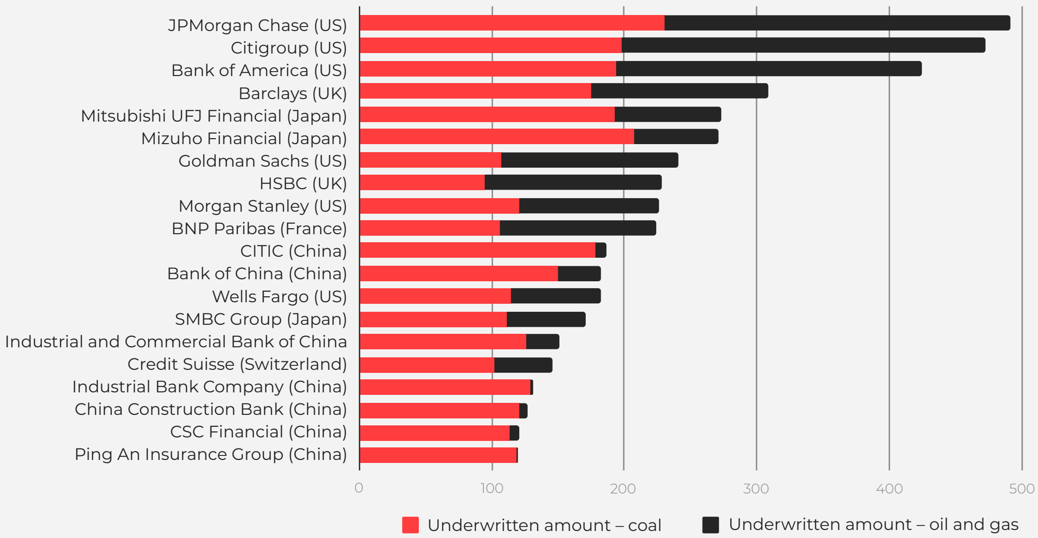
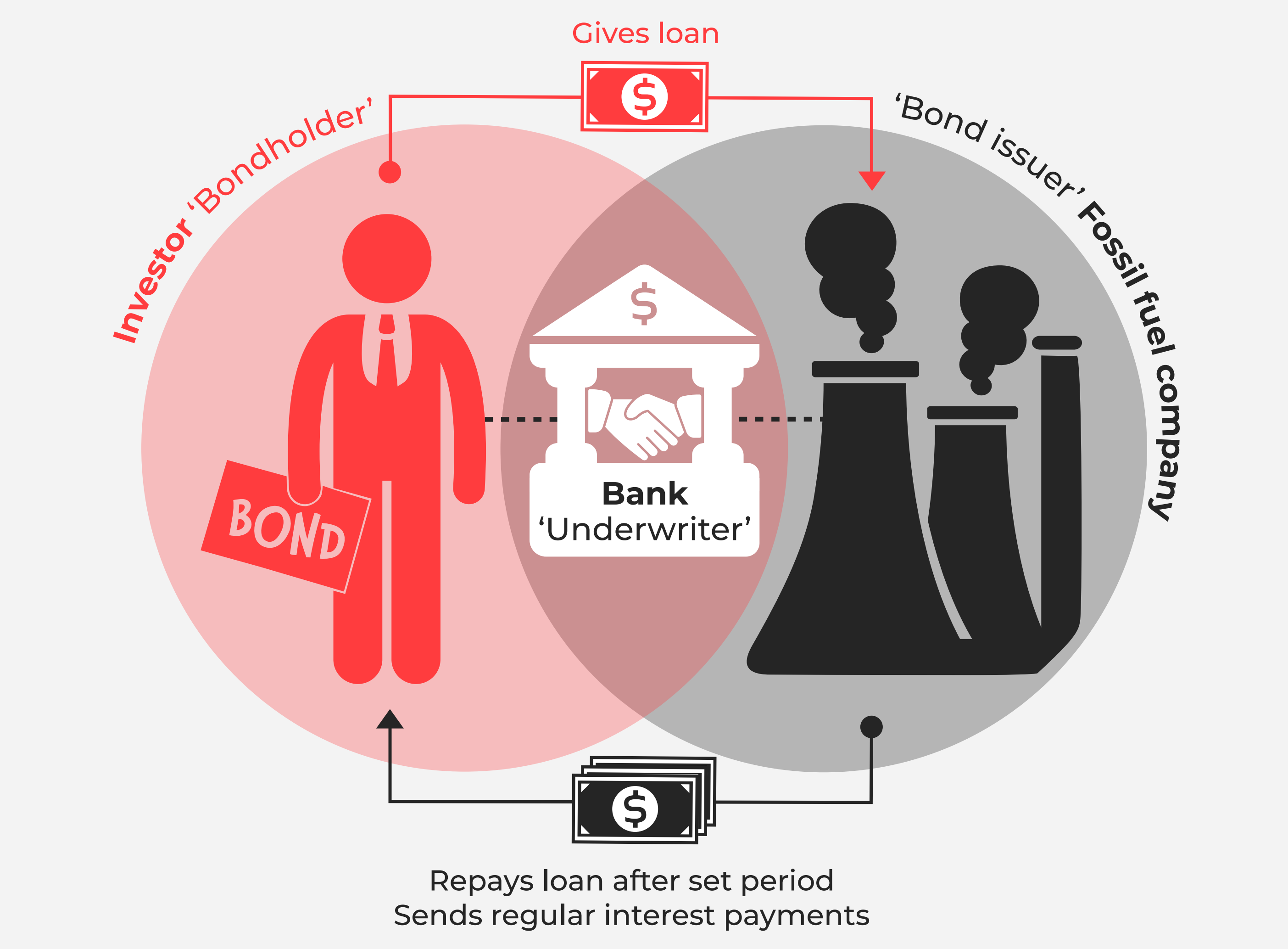


Figure 2: Banks earning the most underwriting fees on fossil fuel bond issuances
(2016-2022, US$ mln)

Source: Refinitiv (2022, January). Bond Issuances: Bloomberg (2022, January). Bond Issuances: IJGlobal (2022, January). Transactions search: Trade Finance Analytics (2022, January). Transactions search: Profundo.

1. How the bond market funds fossil fuel expansion



Companies seeking finance have two main options: equity financing or debt financing.

Equity financing means giving up a percentage of ownership in the company by selling shares. Debt financing means companies have to pay back the funds over an agreed time period, plus interest.

Companies pursuing debt financing can choose one of two routes: a loan from a bank or other financial institution, or by issuing bonds. The bond market is larger than the stock market and more opaque. Bonds often have fewer restrictions compared to bank loans and do not involve handing over any control of the company to investors, as with shareholdings.

Bonds are a debt security, like an IOU, where an investor (bondholders) lends money to a company (issuer) for a set period of time (maturity period) in exchange for regular interest payments (coupon rate = the interest rate of the debt). After the maturity period, the principal sum is repaid to the bondholder.

To issue a bond, a company needs a dealmaker, often several. The bond issuer does not itself sell the bonds. This is where banks come in. Acting as an underwriter (also known as an arranger or bookrunner), banks serve as an intermediary between the companies issuing the bonds and the investors who purchase them. Banks advise companies issuing bonds and help them to market the bonds to investors.

Fossil fuel companies seeking to market their corporate bonds rely heavily on banks' credibility and access to a pool of potential bond investors, making banks complicit in the ensuing climate chaos of fossil fuel expansion.

2. Financing fossil fuel expansion is incompatible with climate pledges

The invasion of Ukraine has caused many countries to reconsider their dependance on Russian fossil fuels. But instead of turning to renewables, the EU is investing billions in new oil and gas pipelines.

> ***The focus must be on energy demand reduction, not fossil fuel expansion, as well as boosting supply from renewable sources***

The International Energy Agency's (IEA's) Net Zero Emissions by 2050 scenario (NZE) found that there is no need for any new oil or gas fields after 2021.[5]

This is because, in a world that limits warming to 1.5 °C, oil and gas consumption will decline at roughly the same rate as production from existing fields, meaning oil and gas in already producing or under-development fields will be sufficient to meet demand.

The NZE is optimistic about the role that technologies like Carbon Capture and Storage (CCS) will play, meaning there is also a risk to already producing oil and gas projects. In the absence of large-scale carbon capture or removal, recent research shows that nearly 40% of developed fossil fuel reserves need to stay in the ground to keep the 1.5°C target in reach.[6]

Therefore, developing new oil and gas fields can have only three outcomes:

- The additional oil and gas will find a market, thus increasing emissions, breaching the 1.5°C limit and leading to more extreme climate impacts.
- Many oil and gas production assets will have to close early, stranding assets.
- A combination of the above.

Clearly, financing fossil fuel expansion – directly or indirectly – is at odds with a transition to a 1.5 degree economy and is in direct contradiction with many banks' own Net Zero pledges and ambitions.[7]

In recent times, the Russian invasion of Ukraine has convinced many countries of the urgent need to reduce their dependence on Russian fossil fuels. However, rather than championing climate-friendly solutions, the EU is investing up to €12 billion in pipelines and Liquified Natural Gas (LNG) terminals to improve access to gas and oil from other countries, including Egypt, Israel and Nigeria.[8]

These new projects, which would take years to go online and do nothing to alleviate the immediate supply and price issues, divert attention and resources from the sort of measures which would. Primarily: reducing energy demand through property retrofitting, alternative heating systems and efficiency measures, as well as boosting supply from renewable sources. What's more, new oil and gas fields exacerbate the twin risks of wasted capital and catastrophic climate change.

3. Underwriting bonds – a loophole in bank action on climate change

As calls for climate action and sustainable finance grow, many large banks have developed Net Zero policies, coal exclusion commitments and emissions reduction targets for sectors such as 'energy' and 'power and utilities'.

However, such targets often only apply – as was the case with Citi[9] and (until they backed down after criticism), HSBC[10] – to the lending activities of the bank, not financial services like underwriting. Likewise, the Net Zero Banking Alliance[11] – the flagship banking sector climate alliance – doesn't, at least yet, appear to require signatories to set targets for underwriting activity.[12] This is a potentially huge loophole which undermines the effectiveness and credibility of such targets and ultimately threatens our chance of meeting the commitments set out in the Paris Agreement.

Underwriting shares and bonds is now the primary way by which banks are helping many fossil fuel companies raise money, making the banking sector complicit in the climate crisis. In 2021, ShareAction found that 57% of the financing provided by European banks to the 50 oil and gas companies covered in this briefing was in the form of underwriting shares and bonds.[13]

Similarly, The Banking on Climate Chaos Report, by Rainforest Action Network and partners, found that from 2016 to 2021, 51% of the fossil fuel financing they identified was provided through such services.[14] Analysis of the Global Coal Exit List and data from company financial statements found that coal companies with the biggest expansion plans raised two and a half times more capital through bond issuance than through bank loans, with bonds becoming the single largest source of financial support for coal in China and India.[15]

This highlights the need for banks to restrict financing at both project and company level, and to cover all relevant financing activities in their policies and targets. Furthermore, campaigners and investors can no longer afford to dismiss the bond market when challenging banks' support for fossil fuel expansion.

Underwriting is now the primary way which banks help many fossil fuel companies raise money.
Credit: Greenpeace/ Hunt.

Excluding underwriting from climate targets – HSBC

In February 2022, following intense pressure from investors and ShareAction, HSBC published targets to reduce their financed emissions for the 'power and utilities' and 'oil and gas' sectors. However, unlike Barclays, HSBC chose to exclude the emissions arising from its capital markets activities, such as underwriting bonds, from its targets.[16] ShareAction pointed out that this was an unacceptable loophole given that 60% of HSBC's financing to top upstream oil and gas companies is in the form of capital markets underwriting. Less than a month later, following investor and campaigner uproar, HSBC announced a U-turn. The bank is expected to announce emissions reduction targets later this year for underwriting. Shareholders welcomed the move but noted they would scrutinise implementation closely. It's vital that HSBC's forthcoming underwriting targets are at least as ambitious as those for lending.[17]

[12] However, the recently released UN Race to Zero criteria, which the NZBA is required to follow, means member banks will, by June 2023, have to publish plans and targets to restrict the development, financing and facilitation of new fossil fuel assets, including underwriting.

4. Our findings: toxic bonds are slipping through the net

Upper Hunter Valley coal mine, New South Wales, Australia.
Credit: Greenpeace/Murphy.

*Since January 2016, banks have provided bond underwriting services totalling **US$2.7 trillion** for coal, oil and gas companies*

We set out to determine just how much money has been raised from bonds since 2016, both by coal companies and those with the biggest oil and gas expansion plans. We wanted to find out which banks play the biggest role in facilitating these companies and determine the fees banks are bringing in for such financing of fossil fuel expansion.

This research used financing data which had already been gathered and published as part of GCEL and ShareAction studies. The GCEL study includes data on over 770 companies along the thermal coal value chain, whose activities range from coal exploration and mining, coal trading and transport, to coal power generation and manufacturing of coal plants. The ShareAction research focuses on the top 50 companies expanding oil and gas production. Only the bond issuance underwriting data has been collected from these studies and used as part of this research.

Bond underwritings were researched for bonds issued on the market in the period January 2016 to November 2021 for coal companies (GCEL) and January 2016 to January 2022 for oil and gas companies (ShareAction).

Financing data used in this briefing was provided by Profundo. The bond underwriting services provided by financial institutions were retrieved from financial databases Bloomberg and Refinitiv. Project finance was gathered through project finance database IJGlobal.

A detailed methodology is set out in the annex.

Banks' corporate bonds business is mostly not included in their fossil fuel climate targets, despite the ***outsized reputational risk and impact on the planet.***

Findings

- Since January 2016, banks have provided bond underwriting services totalling US$2.7 trillion for coal companies and companies leading oil and gas expansion. US$2 trillion went to companies on the GCEL[18] whilst US$700 billion went to the top 50 companies expanding oil and gas production.[19]
- US$925,712 million of those bonds were arranged for the 'Dirty 30' – identified by the Toxic Bonds Initiative as 30 of the top corporations[20] using the bond market to obtain cash to expand coal, oil and gas operations.[21] In some cases, their bond market exposure is large (as in TotalEnergies which has USD/EUR bonds worth nearly $50 billion that are outstanding). In other cases, such as Whitehaven Coal, the company is only set to make their debut bond issuance this year. In all cases, the companies on the Toxic Bonds Dirty 30 list are all planning major expansion and are using the bond market to help finance these plans.
- Two American banks are most involved in fossil fuel bond transactions. Since 2016 JPMorgan Chase arranged $103 billion and Citigroup arranged $99 billion. This is followed by the Industrial and Commercial Bank of China (ICBC) that arranged $95 billion in bonds for fossil fuels. See figure 1.
- Three American banks earned the highest fees from these transactions: JPMorgan Chase (US$492 million), Citigroup (US$473 million) and Bank of America (US$425 million), followed by British bank Barclays (US$308 million) and Japanese bank Mitsubishi UFJ Financial (US$273 million). See figure 2.

Focus banks

- Looking specifically at 22 banks of systemic importance, we found that since January 2016, they provided bond underwriting services for the Dirty 30 companies totalling US$449 billion, of which US$92 billion was for coal and US$356 billion was for oil and gas. 20 of the banks are members of the Net Zero Banking Alliance, suggesting the initiative is having limited impact on banks financing of fossil fuel expansion.[22] See figure 3.
- From facilitating these bond transactions, the 22 banks have earned an estimated US$4.7 billion in underwriting fees, of which US$2.6 billion was for coal and US$2.1 billion was for oil and gas.
- When it comes to the league table of the 22 banks'underwriting fees for the Dirty 30, Citigroup leaps to first place with US$197 million, with its American peers JPMorgan Chase and Bank of America rounding out the top three. HSBC is the leading non-US bank with $110 million in fees. See figure 4.
- Focusing on coal bond issuance only, the top five banks underwriting the largest amounts in bonds for coal companies are all based in China: ICBC ($86 billion), CITIC ($86 billion), Shanghai Pudong Development Bank ($68 billion), China Everbright ($64 billion), and Ping An ($63 billion).
- When it comes to the largest amount of bond underwriting for oil and gas companies, three American banks are at the forefront: JP Morgan ($63 billion), Citi ($61 billion) and Bank of America ($59 billion). They are followed closely by two British banks: HSBC ($34 billion) and Barclays ($33 billion).
- Overall, banks provide large amounts of financing for fossil fuel companies by underwriting bonds. However this business activity is mostly left out of bank climate targets causing toxic bonds to slip through the net. Banks fossil fuel bond underwriting business needs proper scrutiny.

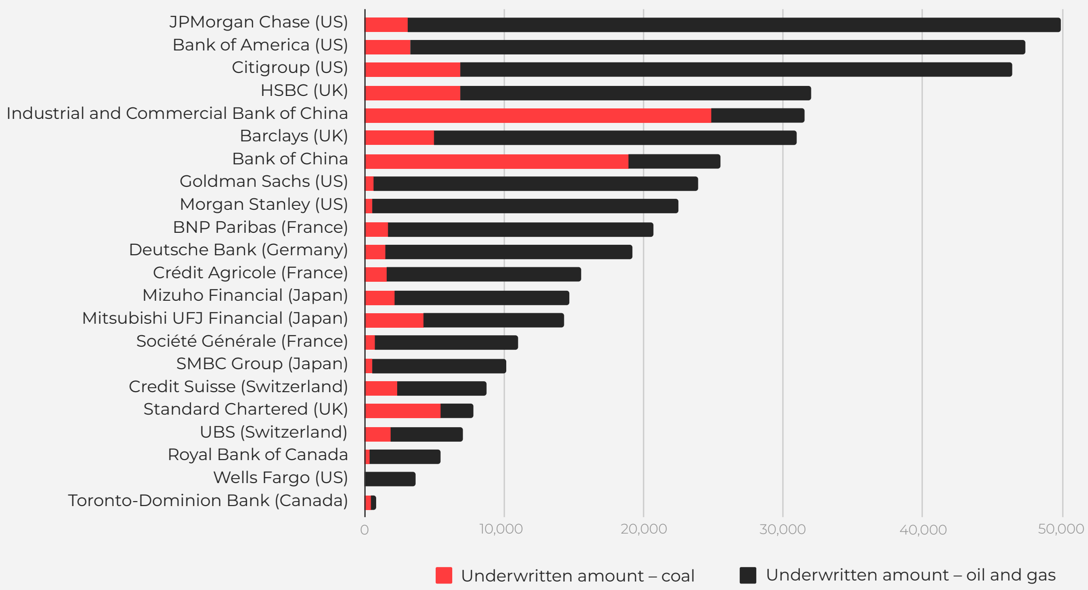


Figure 3:
Fossil fuel bond underwriting to the Dirty 30 companies, from 22 selected banks
(2016-2022, $US mln)

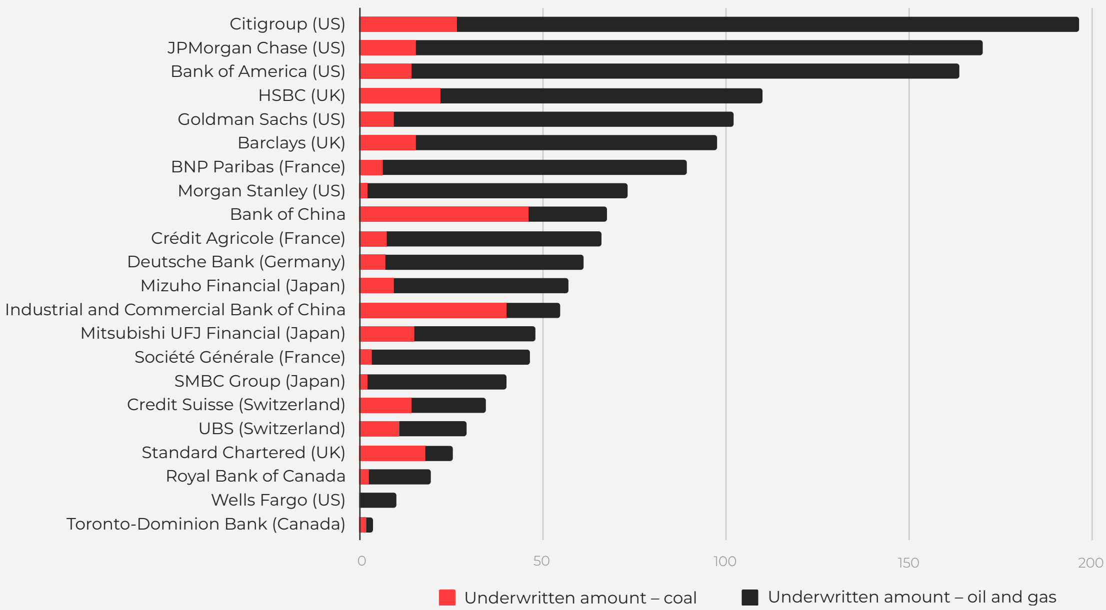


Figure 4:
22 selected banks earning the most underwriting fees on fossil fuel bond issuances for the Dirty 30
(2016-2022, US$ mln)

Source for all data: Refinitiv (January 2022). Bond Issuances: Bloomberg (January 2022). Bond Issuances: IJGlobal (January 2022). Transactions search: Trade Finance Analytics (January 2022). Transactions search: Profundo.

Citi coal policy – the new client loophole

As noted on the Coal Policy tool,[23] Citi [24] is the first US bank to announce a phase-out – even partial – of financing coal by 2030/2040. However, the bank's policy only affects "new clients" so Citi can continue to support coal plant developers until at least 2025, when the bank will require a low-carbon transition strategy from its clients.[25] Furthermore, when Citi set interim targets to reduce its financed emissions from the energy and power sector, it excluded underwriting activity from its calculations of its financed emissions.[26]

5. Recommendations

Open-cut coal in the Hunter Valley. Credit: Dean Sewell.

Any bank supporting expansionist fossil fuel companies is complicit in climate chaos. As such, to champion credible climate action, banks must:

- Include all financing activity – including **the underwriting of bonds** – in their climate policies and financed emissions reductions targets.
- As a priority, the Toxic Bonds Initiative asks that all banks **urgently cease underwriting corporate bonds of the Dirty 30**.

Furthermore, campaigners and investors should:

- Include **an end to the underwriting of toxic bonds** in their fossil fuel and climate demands of banks.

By cutting off this important funding source of the fossil fuel industry, we can stop coal, oil and gas expansion and leave climate-wrecking resources in the ground, limiting global warming within 1.5°C and avoiding the 'global collapse scenario' recently forewarned by the UN.[27]

Until then, banks will continue to prop up the companies that are driving climate breakdown whilst our window of opportunity to tackle this crisis grows ever smaller.

> ***By cutting off this important funding source of the fossil fuel industry, we can stop coal, oil and gas expansion and leave climate-wrecking resources in the ground***

Annex

Detailed methodology

Financial institution financing contributions

Individual bank's contributions to underwriting were recorded to the extent possible where these details were included in the financial databases. In many cases, the total value of an issuance is known, as well as the number of banks that participate in this issuance. However, the amount that each individual bank commits to issuance has to be estimated. This research uses a two-step method to calculate this amount. The first uses the ratio of an individual institution's management fee to the management fees received by all institutions. This is calculated as follows:

Participant's contribution:

$$\left(\frac{\text{individual participant attributed fee}}{\text{sum of all participants attributed fees}} * \text{principal amount} \right)$$

When the fee is unknown for one or more participants in a deal, the second method is used, called the 'bookratio'. The bookratio (see formula below) is used to determine the commitment distribution of underwriters and other managers.

Bookratio:

$$\frac{\text{number of participants} - \text{number of bookrunners}}{\text{number of bookrunners}}$$

Table 1 shows the commitment assigned to underwriter groups with this estimation method. When the number of total participants in relation to the number of underwriters increases, the share that is attributed to underwriters decreases. This prevents very large differences in amounts attributed to underwriters and other participants.

Table 1
Commitment assigned to underwriter groups

Bookratio	Issuances
> 1/3	75%
> 2/3	75%
> 1.5	75%
> 3.0	< 75%*

* In case of deals with a bookratio of more than 3.0, we use a formula which gradually lowers the commitment assigned to the underwriters as the bookratio increases. The formula used for this:

$$\frac{\frac{1}{\sqrt{\text{bookratio}}}}{0.769800358}$$

The number in the denominator is used to let the formula start at 40% in case of a bookratio of 3.0. As the bookratio increases, the formula will go down from 40%.

Bond issuance underwriting fees

When banks underwrite a bond, they calculate and apply underwriting fees. The calculation of the fees depends on several criteria and varies per bank.

Imputed deal fees are often included in data from the financial data providers. Where deal fees are missing, the research provider used a proxy to estimate the amount of underwriting fees applied and earned by the banks. This proxy is calculated using three criteria:

- The currency of the bond issuance,
- The size of the bond issuance (i.e. the principal, in US$ million),
- The maturity date of the bond issued.

It should also be highlighted that the banks consider additional and more specific criteria when calculating the level of fees to apply. Some of these criteria require a case-by-base analysis, such as the risk profile of the issuer or the economic context when the bond is issued. It is not possible, in this research, to assess whether any such criteria were applied.

The proxy used in this research is the average of three sub-proxies:

- The median of imputed deals fees for deals where the fees per financial institution contribution are known per currency, leading to a ratio of deal value to imputed deal fee,
- The median of imputed deals fees for deals where the fees per financial institution contribution are known per size of issuance, leading to a ratio of deal value to imputed deal fee,
- The median of imputed deals fees for deals where the fees per financial institution contribution are known per maturity date, leading to a ratio of deal value to imputed deal fee.

An average is made of the three ratios to lead to one single ratio which combines the analysis of the three criteria (currency, size, maturity). This ratio is applied to deals for which the imputed deal fee is not registered by the financial data service, in order to estimate the imputed deal fee.

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Front cover coal mine photo:
Max Phillips (Jeremy Buckingham MLC).

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