

The Structural Difficulty of Eliminating Financing for Fossil Fuels

Chong Zhang*

Department of Statistics and Mathematics, Zhejiang Gongshang University, Hangzhou, China

DESCRIPTION

If bank funding to the fossil fuel industry is to be rapidly phased out, meeting the Paris climate targets will be essential. In this study, the examination syndicated fossil fuel loan markets using a systems perspective. These markets are a vital source of funding for fossil fuel corporations, and our findings show that they can withstand unplanned and uncontrolled phase-out situations. Phase-out is ineffective in a situation where banks can exchange capital unless capital requirements regulations restrict banks' involvement to the industry. With capital requirements regulations in place, banks gradually leave the industry at a tipping point from inefficient to efficient phase-out.

To keep the rise in global temperature below 1.5°C, the Paris Agreement requires a dramatic reduction in the use of fossil fuels. Investment in new fossil fuel assets is incompatible with agreed-upon temperature targets since projected emissions from currently in production fossil fuel assets take the world's warming above 2°C. The discussion over climate change today centers on the role played by financial institutions in maintaining the "business-as-usual" fossil fuel economy. Campaigns for divestiture aimed at equity investors have been successful in changing public opinion, but they haven't had much of an influence on capital flows to fossil fuel corporations, who derive 90% of their funding from bank debt. In response to growing socio-political pressure on banks to decarbonize their lending portfolios in accordance with Article 2.1(c) of the Paris Agreement, which states that banks must "make finance flows consistent with a pathway towards low greenhouse gas emissions," the UN-convened Net Zero Banking Alliance (NZBA) was established in 2021.

Nonetheless, NZBA signatories have come under fire for allegedly having unrealistic deadlines and misaligning their policies with their statements. Despite the perception that the risk of fossil fuel assets becoming "stranded," or undervalued due to coordinated governmental action, is a long-term one, banks are nonetheless financially motivated to retain medium-term investments in fossil fuel assets. An individual bank's contribution to fossil fuel lending extends beyond its own assets through the practice of debt syndication, in which several banks pool their resources for a single transaction in the bonds and loans markets. Debt syndication is a crucial tool for the capital-intensive fossil fuel industry; between 2010 and 2021, it accounted for 81% of fossil fuel financing. This is because it enables agreements that are too large for a single bank's balance sheets and distributes risk across syndicate members. Additionally, in the fossil fuel debt markets, syndication builds networks of lending agreements that enable capital to be substituted between banks with varying views on the climate transition and throughout the global financial system, which is unevenly exposed to climate policy. It will be necessary to conduct a systemic review of the syndicated debt flows to the fossil fuel industry if lending to this sector declines quickly. The network techniques has been employed to investigate the landscape of fossil fuel financing, building on complexity approaches to the study of socio-economic systems, which have shown particularly useful for researching financial risk. Network models of the fossil finance phase-out, emphasizing the role of capital substitution the ability of a bank to replace its phased-out capital with that of another has been created. To demonstrate how capital substitution prevents a drop in fossil fuel lending across the system and how prudential regulation, such as capital requirements laws, might mitigate this phenomena. These topics are now being explored by policymakers and civil society.

Correspondence to: Chong Zhang, Department of Statistics and Mathematics, Zhejiang Gongshang University, Hangzhou, China, E-mail: zhang@gmail.com

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