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GUIDELINES
on Environmental Risk Management for Banks

Contents

1. General provisions

1.1. These Guidelines have been developed based on the 'Sustainable Finance Roadmap 2023-2026' of the Central Bank of the Republic of Azerbaijan (hereinafter - the Central Bank) and advanced international experience and provide recommendations on environmental risk management in banks.

1.2. The Central Bank considers financial risks arising from climate change and other environment-related factors as one of the main financial stability risks in the medium and long term and has included ensuring banks' resilience to these risks among its strategic objectives.

1.3. These Guidelines aim to integrate environmental risks into banks' risk management and ensure that banks are resilient to these risks.

1.4. The recommendations contained in the Guidelines are minimum requirements and are applied taking into account each bank's sensitivity to environmental risks, business environment and risk profile.

2. Definitions

2.1. The terms used in these Guidelines have the following meanings:

2.1.1. **Environmental risks** – risks caused by climate change, environmental problems such as environmental pollution, degradation of natural resources and biodiversity, and water scarcity.

2.1.2. **Climate-related risks** – risks arising from exposure of banks to physical and transition risks due to climate change.

2.1.3. **Physical risks** – risks resulting from an increase in the frequency and severity of sudden natural events (floods, droughts, wildfires, landslides, storms, *etc.*), and gradual changes in climate indicators (temperature rise, increased precipitation, sea level rise, *etc.*).

2.1.4. **Transition risks** – risks that can arise in the process of adapting to a low-carbon economy (*e.g.,* changes in the legal and technological environment, changes in customer behavior).

2.1.5. **Greenhouse gas emissions** – harmful gases released into the environment from bank's direct and indirect activities, which are divided into three categories:

2.1.5.1. **Scope 1 emissions –** emissions from the bank's direct activities (for example, harmful gases released into the air from bank's vehicles).

2.1.5.2. **Scope 2 emissions –** emissions resulting from the energy sources used by the Bank (including harmful gases emitted into the air to produce the energy used by the bank).

2.1.5.3. **Scope 3 emissions –** emissions caused by the bank's financing its clients (e.g., harmful gases emitted into the air by the financing and implementation of carbon-intensive economic activities).

3. Corporate governance framework for environmental risks

3.1. Taking into account these Guidelines, the bank's Supervisory and Management Boards ensure the integration of environmental risks into the bank's risk appetite, strategy, and business plans. In this context, the identification of environmental risks and opportunities arising from the transition to a low-carbon economy and their potential short-, medium- and long-term impact on the bank's strategy and business model are assessed. The bank's Supervisory and Management Boards also ensure the integration of environmental risks into the bank's risk management system and the effective control of assessing, managing, monitoring, and reporting these risks, considering these Guidelines.

3.2. The bank's environmental risk policy is aligned with the country's Nationally Determined Contributions (hereinafter - NDCs) stipulated in the Paris Agreement adopted at the 21st Conference of the Parties to the United Nations Framework Convention on Climate Change.

3.3. In the area of environmental risk management, the Supervisory Board:

3.3.1. approves and monitors the implementation of the environmental risk management policy.

3.3.2. ensures the inclusion of relevant qualitative and quantitative environmental risk indicators in the risk appetite statement. Qualitative indicators may include the bank's approach to environmental risk management, and quantitative indicators may include limits applied to sectors or clients that are significantly sensitive to environmental risks.

3.3.3. identifies a person responsible for environmental risk management at the level of a member of the Management Board.

3.3.4. defines the duties and powers of bank's managing bodies, including the person responsible for environmental risk management.

3.3.5. establishes internal accountability framework for environmental risks.

3.4. In the area of environmental risk management, the Management Board:

3.4.1. develops and submits to the Supervisory Board for approval the environmental risk management policy.

3.4.2. ensures the implementation of the environmental risk management policy.

3.4.3. reviews the effectiveness of the environmental risk management policy, tools, and indicators on a regular basis, taking into account the changes in the bank's risk profile and business strategy, and makes appropriate adjustments, if necessary.

3.4.4. analyzes the environmental risks to which the bank is exposed and take the necessary measures to reduce the risks with a significant impact.

3.5. The person responsible for environmental risk management:

3.5.1. prepares proposals for environmental risk management policy.

3.5.2. coordinates the implementation of the environmental risk strategy and policy at the level of banks’ all structural units and integrate them into its three lines of defense.

3.5.3. prepares proposals for the inclusion of environmental sustainability factors in the business strategy, risk appetite statement and risk management system.

3.5.4. prepares proposals for strategic initiatives aimed at achieving the goals set by the bank on environmental risks and sustainability.

3.5.5. provides expert support to the Supervisory and Management Boards on environmental risk management and sustainability matters.

3.5.6. identifies the bank's internal potential for environmental risk management and organizes related training programs.

4. Internal policies and procedures on environmental risk management

4.1. The bank develops a risk management framework to manage environmental risks systematically and consistently. This framework:

4.1.1. clearly describes environmental risk management duties and responsibilities of business units and functions.

4.1.2. identifies and evaluates environmental risks at the client and portfolio level.

4.1.3. implements effective risk management practices and the internal control system for environmental risk management.

4.1.4. Timely notifies the Supervisory and Management Boards on environmental risks.

4.2. Environmental risk management duties and responsibilities are clearly allocated in the bank in accordance with the three lines of defense model considering the following:

4.2.1. Environmental risks are regularly assessed by business-oriented structural units both before establishing business relations with customers and throughout the duration of such relations (Defense line 1).

4.2.2. The risk management function monitors compliance with the bank's environmental risk management policy by Defense line 1, while the compliance function assesses compliance with relevant regulations (Defense line 2).

4.2.3. The internal audit function evaluates the reliability of the environmental risk management system of the bank (Defense line 3).

5. Identification and evaluation of environmental risks

5.1. The bank identifies key environmental risks at the client and portfolio levels and assesses their potential impact on its operations.

5.2. Risk criteria are defined to identify sectors that are highly sensitive to environmental risks. These criteria may include the following indicators:

5.2.1. the level of greenhouse gas emissions.

5.2.2. vulnerability to extreme weather events.

5.2.3. water scarcity.

5.2.4. drought.

5.2.5. deforestation.

5.2.6. pollution.

5.3. The environmental risk policy framework defines the bank's expectations for existing and new customers in sectors that are highly sensitive to environmental risks, as well as their environmental risk management strategies. In such cases, internationally accepted sustainability standards and certification tools can be utilized.

5.4. The bank measures 1st, 2nd, and 3rd scope emissions. Scope 3 emissions are measured for business loans. General recommendations for measuring greenhouse gas emissions for business loans are provided in Annex 1 to these Guidelines.

5.5. The bank conducts an environmental risk assessment for each customer within the framework of its lending activities. External ratings may be used in this process. The following factors are taken into account during the evaluation:

5.5.1. the customer's susceptibility to physical and transition risks.

5.5.2. customer's competence, responsibility, and experience in managing the risks.

5.6. The scope and depth of the assessment are determined based on the sector in which the customer operates, as well as the characteristics and volume of their operations.

5.7. A more in-depth assessment is conducted for operations (activities) highly sensitive to environmental risks, including on-site inspections of his/her business activities and obtaining opinions from internal and external experts specialized in environmental issues. If necessary, the appropriateness of such operations is reviewed at the internal committee or management level.

6. Regulation and monitoring of environmental risks

6.1. The bank proactively manages environmental risks at both the customer and portfolio levels. The customer's activities are regularly monitored to ensure the timely detection of any actions that may harm the environment or violate the bank's policies.

6.2. The following methods and approaches are used to manage risks at a customer level:

6.2.1. Any customer whose environmental sensitivity is above the acceptable level set by the bank is encouraged to improve the environmental risk profile and gradually transition to a sustainable business. The following mechanisms can be used for the purpose:

6.2.1.1. The customer may be required to reduce the level of environmental risk to an acceptable level by meeting specific legal and financial conditions (covenants) outlined in the agreement. These conditions may include the development and implementation of a strategy for transitioning to a sustainable business model, as well as compliance with relevant certifications and industry standards.

6.2.1.2. Determination of environmental action targets (result indicators) for the customer in agreement with him/her. Such targets may include actions such as reducing the customer's carbon emissions and improving energy efficiency.

6.2.1.3. Ensuring that the customer's business is insured to reduce or maintain an acceptable level of environmental risks. To this end, the bank can support its customers by helping them choose suitable insurance products and manage risks more effectively.

6.2.2. when determining actions for customers whose environmental risks exceed the acceptable level set by the bank, the following factors are considered: the scale of the risk, the relationship with the customer, customer's willingness, and capability to improve his/her environmental risk profile, and whether alternative methods to reduce environmental risks are available.

6.2.3. The bank may establish appropriate incentive mechanisms for customers who effectively manage their environmental risks, helping them achieve the goals needed to bring their environmental risks to an acceptable level. Such measures may include lower interest rates, favorable limits on the loan amount, and other similar incentives.

6.2.4. The bank regularly educates its customers about environmental risks and opportunities and encourages them to disclose such risks related information and behave responsibly.

6.3. The following quantitative and qualitative tools can be applied to manage environmental risks at the portfolio level:

6.3.1. assessment of portfolio risks for geographical areas and sectors with high sensitivity to environmental risks.

6.3.2. measuring the carbon intensity of customers in high-risk sectors.

6.3.3. consideration of environmental risks in relation to collateral during the collateral appraisal.

6.3.4. ensuring compliance of the loan portfolio with the targets set by the NDCs for environmental risks of the country.

6.3.5. assessment of the dependency of key customer segments on natural ecosystems using risk indicators for customers and portfolios. These indicators may include the impact of water scarcity on customers' financial performance or the effect of biodiversity loss on profitability of relevant sectors such as product manufacturing, food production, and processing industries. When identifying environmental risk indicators, the scale of ecological risk factors is taken into account. If risks are significant, the bank takes actions to mitigate them. For instance, such measures may include adjusting portfolio concentration in geographically sensitive areas and sectors with high environmental risk sensitivity.

6.4. Environmental risks are taken into account when identifying and managing the following key risks faced by the bank:

6.4.1. **credit risk:** The high frequency and severity of extreme weather events could reduce the value of assets owned by banks' customers or adversely affect customers' operations, profitability, and supply chain. The transition to a low-carbon economy may also affect the business performance of customers operating in carbon-intensive industries. In addition, actions taken by relevant public authorities against customers whose activities cause environmental pollution (e.g., fines, cancellation of operating permits) may result in a significant financial impact on these customers. Water-related risks (e.g., water scarcity, water pollution, drought) may increase operating costs for companies operating in water-intensive sectors. These factors may reduce customers' ability to meet their debt obligations and lead to the devaluation of collateral held by banks, which can increase the credit risk for banks. In this regard, environmental risks are integrated into the framework of evaluation and monitoring of credit applications. In this regard, the framework for managing credit risks related to environmental factors includes the concentration arising from sectorial, geographic, and individual customers, as well as from physical and transition risks. At the same time, potential changes that may occur in the correlation relationship between different asset categories are taken into account. Credit limits may be applied to significant environmental risks in accordance with the bank's risk appetite.

6.4.2. **market risk:** factors such as environmental and climate change natural disasters, global warming and extreme weather events can affect prices and economic activity in investment markets. Rising water levels or frequent floods can reduce values of property and infrastructure located near riverbeds, which can adversely affect portfolios of banks investing in respective assets. Fluctuations in energy prices may increase risks for banks investing in traditional energy sector activities, particularly in relation to the increased use of renewable energy sources. In addition, amendments to the policy and legislation related to climate change, carbon emission restrictions are among the factors affecting market risks. The bank evaluates and regularly monitors the impact of these changes on its market risk profile. For this purpose, a methodology for measuring market risks arising from environmental factors is developed using advanced international standards and practices, and effective tools are applied to manage significant risks.

6.4.3. **liquidity risk:** an increase in the intensity of natural disasters can result in extensive physical damage to properties. The need for financial resources for repairs and restoration can lead to increased deposit withdrawals from banks, a rise in loan applications, and, consequently, liquidity problems for banks. Banks may also face difficulties in liquidating properties damaged by extreme weather conditions, or properties depreciated by the transition to a low-carbon economy. Additionally, depositors and investors who are aware of and sensitive about environmental issues may reconsider their investment in an organization with a negative image in this regard. The bank assesses the impact of environmental risks on its liquidity position and makes appropriate changes to its liquidity risk management framework and liquidity position when a significant impact is detected.

6.4.4. **operational risk:** an increase in severe weather conditions can affect the bank's infrastructure, operations and employees and impede business continuity. The bank assesses the impact of environmental risks on its activities, control system and operating environment. The assessment covers all business areas and operations, as well as operations provided by third parties. The impact of environmental risks on the continuity of bank's activities is taken into account.

6.4.5. **reputational risk:** This risk may arise from banks financing customers engaged in business activities that negatively impact the environment, especially considering growing societal awareness about climate and environmental issues. A negative attitude towards such financing activities may adversely affect banks' ability to maintain or establish business relationships. The bank works to increase its credibility among customers, investors, and other partners by maintaining transparency and reporting standards while implementing climate change adaptation and mitigation strategies. This process includes active awareness campaigns through social media and corporate communications, as well as widespread promotion of climate-related initiatives. The bank also prepares an appropriate action plan and takes active measures to prevent any climate-related reputational risks it may face.

6.5. The bank's contingency plan includes environmental risks (mainly physical risks) and mitigation measures.

7. Scenario analysis and stress tests

7.1. Scenario analysis and stress-test tools are used to assess the impact of significant environmental risks on the bank's risk profile and business strategy, as well as financial stability under various scenarios.

7.2. Possible scenarios are defined and simulated taking into account interactions between environmental and other risks. Both qualitative and quantitative criteria are included in the scenarios and financial stability is predicted under baseline and stress scenarios. The bank forms appropriate internal potential for scenario analysis and stress-testing of environmental risks.

7.3. Short- and long-term environmental scenarios are included in stress-testing programs for strategic planning and risk management purposes. The scenarios cover physical and transition risks, are conservatively designed, and regularly updated.

7.4. Scenarios can be developed for physical and transition risks in consideration of the climate scenarios delivered by the Network for Greening the Financial System (NGFS[1]). For instance, physical risks related climate changes and the effect of extreme events on assets in customers' portfolios, their return and default probability can be assessed. Regarding the transition risk, changes in the government's policy framework for carbon-intensive activities, the impact of the increase in the cost of those activities (through the carbon tax and other mechanisms) on customers' cash flows and creditworthiness can be analyzed.

7.5. Future-oriented forecasts are considered along with historical indicators when defining scenarios.

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[1] Network for Greening the Financial System

7.6. Results of scenario analysis and stress tests are considered when defining or revising environmental risk management policies and procedures.

8. Data disclosure and reporting

8.1. The bank discloses its environmental risk management approach, as well as information on key environmental risks and their potential impact on the bank's sustainability at least annually.

8.2. The composition and structure of the information disclosed by the bank regarding environmental risks is determined in accordance with international standards, including the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD[2]) of the Financial Stability Board, and includes at least the information on:

8.1.1. the role of Supervisory and Management Boards and other management in environmental risk management, including the assessment and regulation of climate risks and opportunities.

8.1.2. the key environmental risks (current and future) that the bank is exposed to and emerging opportunities, their impact on bank's business activities, strategy, and financial planning.

8.1.3. identification, assessment, and management of environmental risks by the bank, related indicators and targets.

8.1.4. information on the volume of the bank's Scope 1 and Scope 2 emissions, as well as Scope 3 emissions financed by the bank.

8.2. The framework for disclosing information related to environmental risks is regularly reviewed, taking into account relevant international standards and methodological documents, with necessary adjustments made accordingly.

8.3. To effectively manage environmental risks, the bank's structural unit engaged in the risk management function develops an internal report on climate risks the bank is exposed to. The report contains information on climate risks to which the bank is exposed, the adequacy of these risks to the bank's risk management policy, as well as the impact of risks on bank's capital.

8.4. Reports are prepared at least on a semi-annual basis and are submitted to the Risk Management Committee (RMC) by the Management Board. After the review by the RMC, reports are submitted to the Supervisory Board of the bank.

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[2] Task Force on Climate-Related Financial Disclosures

Annex 1

to the 'Guidelines on environmental risk management for banks'

General recommendations on the measurement of Scope 3 emission

When banks provide financial services, they affect the environment through borrowers. This impact is classified as a Scope 3 emission (financed emission). The Bank calculates the amount of financed emission using international standards such as PCAF[3] and GHG Protocol[4]. Those standards provide standardized methodologies and emission factors for banks to calculate and disclose greenhouse gas emissions in accordance with financial services.

By applying the mentioned standards, Scope 3 emission is calculated as follows:

1. The financial services to be included in the assessment are determined. These include business loans and investments that finance activities emitting greenhouse gases.

2. The volume of business loans and investments allocated to companies operating in individual sectors (for example, agriculture, manufacturing, energy) is calculated.

3. The emission factor is determined for each sector. The emission factor reflects the amount of emissions per unit of service and goods for each sector.

4. The amount of financed emission is calculated using the emission factor. For instance, the amount of the loan granted by the bank to a company operating in the oil sector, when multiplied by the emission factor for the oil sector, determines the volume of emissions financed by that loan.

5. Summary: The total emission of the bank's financial portfolio is calculated after calculating emissions for various financial products and sectors.

[3] The Partnership for Carbon Accounting Financials

[4] Greenhouse Gas Protocol