



AZƏRBAYCAN RESPUBLİKASININ
MƏRKƏZİ BANKI

SUSTAINABLE FINANCE REPORT

2023



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Governor's foreword

Climate change is one of the most pressing challenges on the global agenda today. We must take determined and unwavering actions today to create a sustainable, low-carbon future. This demand is reshaping a new approach to the financial landscape we are accustomed to by accelerating economic transformation.

The financial industry holds significant potential to address the existential threat posed by climate change and drive the shift towards a sustainable future. By financing the decarbonization of economies, the financial system plays a pivotal role in global efforts to reduce carbon emissions. Central banks bear a crucial responsibility in ensuring sustainable financial flows and supporting the overall goals of the Paris Agreement initiatives.

While central banks grapple with the pressing issue of high inflation worldwide, efforts to facilitate the transition to sustainable finance remain ongoing. Given the context of climate change and environmental risks, it is widely acknowledged that adapting economic activities is unavoidable. The shift towards sustainable finance will naturally align with economic dynamics and present novel opportunities. Central banks play a crucial role in this transition by implementing effective mitigation and control measures during the transformation period. Additionally, they closely monitor social and governance factors, with a primary focus on climate-related and environmental risks.

The Central Bank of Azerbaijan has prioritized supporting the financial sector's shift towards sustainable finance. This aligns with global challenges and Azerbaijan's vision for green growth. Our focus is on effectively managing dynamic changes in the financial sector, guided by the corporate value of 'development.' We are truly committed to ensuring financial stability and contributing to sustainable economic development. By promoting innovations in green finance, we can mitigate systemic risks posed by climate change. I sincerely believe that by aligning our operations with sustainability goals, we can set an example for the broader financial community. Together, we can create a future where economic well-being and environmental sustainability coexist.

The Sustainable Finance Report outlines the Central Bank's efforts in sustainable finance, aligning with its mandate to ensure financial stability. It serves as a transparent account of the Central Bank's sustainable finance initiatives for the financial sector, society, and all stakeholders. The Central Bank aims to enhance sustainable finance by collaborating with relevant stakeholders, evaluating climate-related and environmental risks in the financial industry, fostering an ecosystem for sustainable financial flows, and supporting sustainability disclosures. The upcoming international event, COP29, hosted in our country in 2024, is expected to positively impact the creation of a sustainable financial ecosystem and attract green investments from foreign sources.

Taleh Kazimov

Governor

About the Report

This Report covers the work done by the Central Bank in 2023 on the transition of the financial sector to a sustainable financial market. This Report has been prepared to ensure transparency in the field of sustainable finance, guided by international best practices. With this Report, The Central Bank aims to inform financial market participants, stakeholders, and the general public about integrating sustainable finance into the financial sector's development priorities and implementing the Sustainable Finance Roadmap: 2023-2026. This inaugural Sustainable Finance Report will be regularly updated and accessible to the public.

The Report is divided into three sections: initiatives at the national level, implemented actions, and actions planned. *The first section* discusses the country's sustainable socio-economic development agenda and the financial sector's opportunities for sustainable finance, as well as the risks posed by climate change; *the second section* describes the Central Bank's efforts in introducing sustainable finance; and *the third section* looks at the next steps to be taken.

FIRST SECTION

1. National Strategy for Sustainable Socio-Economic Development

Azerbaijan participates in international initiatives related to climate change and integrates them into national development priorities. Azerbaijan has been a party to the United Nations Framework Convention on Climate Change (UNFCCC) since 1995. According to the NDC document submitted to the UNFCCC in 2016, Azerbaijan aims to reduce the amount of GHG emission by 35% till 2030 compared to the base year of 1990. In addition, the National Coordination Council for Sustainable Development was established by the Decree of the President of the Republic of Azerbaijan in 2016 to implement the commitment stemming from the UN 2030 Agenda for Sustainable Development.

The 2021 United Nations Climate Change Conference, more commonly referred to as COP26, held in Glasgow, set new targets. Thus, Azerbaijan has a new goal to reduce GHG emissions by 40% till 2050 and to create a "zero emission zone" in the liberated territories. To achieve these goals, it is planned to increase the share of renewable energy in total energy production to 30% by 2030.

The Sustainable Development Goals (SDGs) have been integrated into the country's list of national development priorities until 2030. Thus, "Azerbaijan 2030: National Priorities for Socio-Economic Development", approved by Decree of the President of the Republic of Azerbaijan dated February 2, 2021, defines five national priorities to be implemented in the next decade:

1. a steadily growing, competitive economy,
2. a dynamic, inclusive society based on social justice,
3. a place for modern innovations and competitive human capital,
4. the great return to the territories liberated from occupation,
5. a clean environment and a country of "green growth".

At the same time, the mentioned national priorities are of special importance for the implementation of the commitments arising from the UN "Transforming our World: The 2030 Agenda for Sustainable Development". The "Socio-Economic Development Strategy for 2022-2026", developed for the implementation of the national priorities, is aimed at the implementation of the SDG. The reform agenda of the government of Azerbaijan on sustainable development is focused on applying clean technologies, promoting the use of clean energy sources, recycling and rehabilitating polluted areas.

In addition to the transition risk that Azerbaijan's economy will face as it transitions to low-carbon economic sectors, physical risks are also important (see Appendix 1). According to the research of the World Bank, for Azerbaijan, which has a mountainous geographical area, the rising temperature (average annual temperature has increased by 0.4°C-1.3°C over the past 100 years) and the variable precipitation norm necessitates taking mitigation and adaptation measures to confront physical risks (floods, droughts, landslides, heat waves, etc.).

Increasing the use of renewable energy sources in Azerbaijan is one of the priority directions. In 2020, the State Agency for Renewable Energy Sources was established at the Ministry of Energy of the Republic of Azerbaijan. Also, in 2021, the Law of the Republic of Azerbaijan “On the Use of Renewable Energy Sources in Electricity Generation” was adopted. In addition, renewable energy facilities such as bioenergy, solar and wind power (e.g., Nakhchivan Solar Power Station, Pirallahi Solar Power Station, Yeni Yashma Wind Power Park, etc.) have been commissioned and work in this direction is ongoing.

2. Financial Sector Opportunities and Risks

Greening and decarbonization trends in the global economy create opportunities for developing Azerbaijan's non-resource economy and green financing. It is inevitable that the acceleration of these trends will have an impact on the country's oil revenues in the medium and long term. Reduced oil revenues due to declining demand for oil in the global energy market need to be compensated. Climate change, as well as greening and decarbonizing policies, create new opportunities for green financing along with economic costs.

Financing private sector initiatives, such as innovations and implementation of green technologies, to adapt their business models to greening and decarbonization policies, creates opportunities for the financial sector. Realization of these opportunities requires an appropriate ecosystem for managing climate-related and other environmental risks in the financial sector and for providing green finance.

Based on the preliminary findings by the World Bank, physical and transition risks are unlikely to go unnoticed by financial markets, especially by banking sector. For example, energy-intensive sectors may face solvency problems due to higher production costs and transition to greener activities (transition risks). Extreme weather and nature-related events can cause direct and indirect damage to assets, as well as disrupt supply chains and business models (physical risks).¹ According to preliminary estimates, 55% of the banking sector's loan portfolio is exposed to climate-related economic sectors², requiring timely and adequate actions to address the physical and transition risks in the financial system. Financial institutions' implementation of sustainable/green financing actions is currently fragmented. Although the green portfolio is small, the interest of financial institutions in this direction is on the rise and expansion of the portfolio is not excluded.

In light of the above, in order to ensure the financial sector's long-term resilience to climate and ESG risks and the realization of the sustainable and green finance opportunities, the Central Bank has included the transition to sustainable finance among financial sector development priorities.

¹ For example, agriculture is considered to be an industry sensitive to physical risks.

² The Climate Policy Relevant Sectors (CPRS) include high GHG emitting sectors (energy, industrial processes, agriculture, waste, etc.), high carbon intensity sectors (mining, construction, transportation), and sectors sensitive to transition risk transmission channels.

SECOND SECTION

3. Central Bank's Sustainable Finance Agenda

For the implementation of the socio-economic development strategy and the realization of the national priorities determined for the key economic sectors, it is necessary to provide financial flows based on ESG principles. In recent years, due to the consequences of climate change and environmental risks, causing significant financial losses, the integration of sustainable financial factors into the strategic decision-making process of financial institutions has become relevant. Sustainable finance is a new paradigm aimed at adapting the financial sector to the risks associated with ESG factors. The role of the financial system in supporting the transition to a sustainable economy is exceptional. International financial institutions, central banks, and international standard-setting organizations are forming initiatives at the global and regional levels to develop a framework for sustainable finance. For central banks and financial regulators, it is important to integrate sustainable finance into their analytical and policy frameworks (Graph 1). The focus on sustainable finance by regulatory bodies and central banks has significantly intensified in recent years. CBAR has made the transformation of the financial sector towards sustainable finance one of its strategic priorities to support the adaptation of the country's economy to the imperatives of sustainable development.

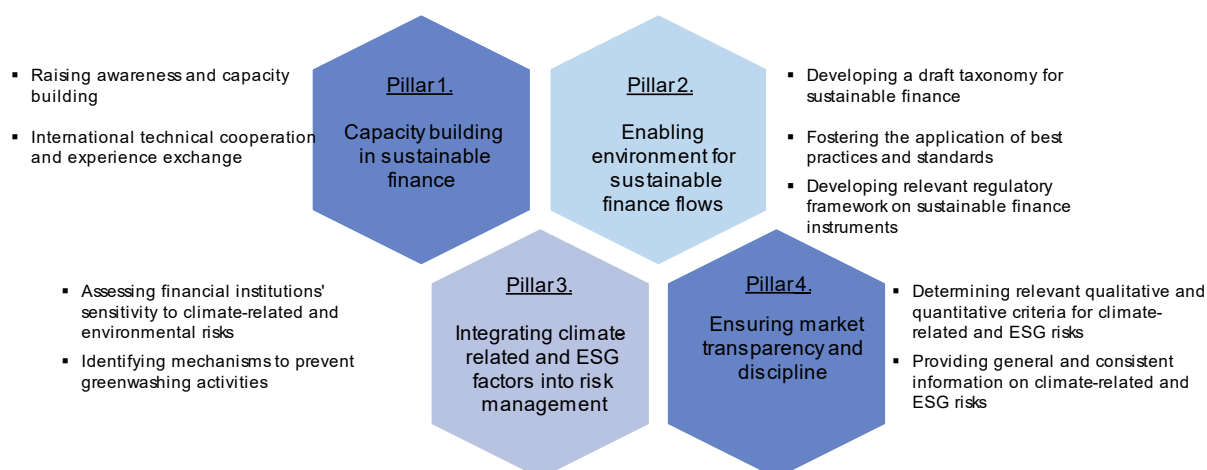
Graph 1. The need for central bank involvement in addressing climate change issues



In order to support the strengthening of the role of the financial sector in the sustainable development of the country and to ensure sustainable financial flows, the Central Bank has developed the Roadmap for Sustainable Finance for 2023-2026. The ultimate objective of this Roadmap is to promote emergence of sustainable finance, which takes into account climate-related and environmental risks, as well as social and governance factors and to ensure financial stability. The Roadmap includes integrating climate-related and ESG factors into financial institutions' financial and investment decision-making and risk management processes by following international best

practices, developing relevant standards and principles to guide financial market participants, and creating an ecosystem for sustainable financial instruments. The above actions are structured according to the 4 pillars of the Roadmap (Graph 2.). The respective work done under each pillar is summarized in the next parts of this section.

Graph 2. Pillars of the Roadmap



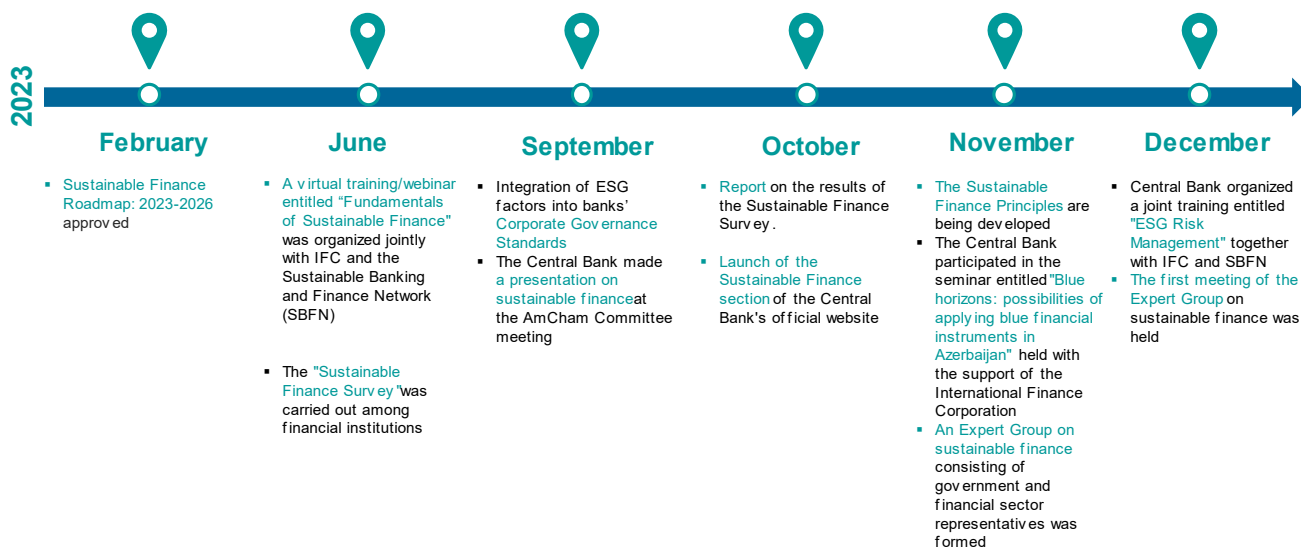
The Roadmap is a multifaceted set of measures for the establishment of a sustainable financial ecosystem.

The Roadmap includes integrating climate-related and ESG criteria into the Central Bank's regulatory framework, as well as into the strategic decision-making and risk management system of financial institutions, shaping relevant market standards in this area, and creating an ecosystem for sustainable financial instruments in line with international best practices. The defined wide-ranging Action Plan covers various segments of the financial sector, as well as involves coordination and cooperation with relevant stakeholders (government institutions, industry associations, international partners, *etc.*) on a number of actions. Graph 3 provides a brief chronology of the Central Bank's work under the Roadmap in 2023.

The transition to sustainable finance will be gradual, taking into account the structure of financial markets.

Awareness raising, knowledge and experience sharing and capacity building initiatives will cover all segments of the financial sector. The integration of climate change and ESG factors into the investment and financing decision-making and risk management processes of financial institutions will be regulated on a voluntary basis, supported by the issuance of guidelines and standards in the first stage, and incorporated into the regulatory framework in the next stage. Considering the advanced international experience and market conditions in the financial sector, the actions defined in the Roadmap will be implemented in a structured manner.

Graph 3. Actions implemented in 2023 on the Central Bank's Agenda for Sustainable Finance



3.1. Capacity building

Capacity building for financial institutions on sustainable finance. In collaboration with IFC experts, a series of training sessions were held in 2023 for financial institutions (banks, insurance and investment companies) on integrating ESG principles into the corporate governance system, transformation models for the transition to sustainable finance, management of ESG risks and accountability for sustainable finance. The training sessions covered ESG risk management, the environmental and social risk management system, the roles and responsibilities of staff in charge of this system, corporate governance aspects, standards and frameworks for sustainable financial responsibility, and practical classes. In addition, CBAR gave presentations at events organized by both financial market associations and international financial organizations.

Participating in the international initiatives and collaborating with other central banks or financial supervisors on sustainable finance. In this regard, a visit to the Central Bank of Georgia was organized on 08-09 November, 2023 for the purpose of exchanging experience. As part of the internship program, the Central Bank of Georgia's experience in developing a national coordination platform for the application of sustainable finance, developing a taxonomy, applying sustainable financial instruments, and assessing climate change and ESG risks was studied. In order to study and exchange international experiences, an application has been made for membership of the Network of Central Banks and Regulators for Greening Financial System (NGFS), which is considered to be the most important international institution in this field. Discussions on the membership process are currently underway.

Building sustainable finance knowledge hub on CBAR's website. A sustainable finance knowledge hub has been created on the Central Bank's official website to promote sustainable finance awareness. This section provides both financial institutions and the general public with news, reports and other information on sustainable finance.

3.2. Enabling environment for sustainable finance flows

Integrating ESG principles into the banks' corporate governance standards. These changes include incorporating sustainable finance and ESG concepts into the regulatory framework and integrating sustainable financial risks into the bank's strategic planning, risk management, and corporate governance systems. According to the new requirements, in order to ensure the long-term stability of the bank, the bank's strategy should include environmental (climate change, environmental degradation, ecosystem disruption, *etc.*), social (gender issues, inclusion, labor relations, investments in human resources, *etc.*) and governance (organizational structure, compensation, employee relations, diversity and equity, *etc.*) factors (ESG factors). In addition, the new standards require that the Central Bank be informed of the risks and deficiencies that negatively affect the bank's stability indicators, as well as the measures taken and/or to be taken to address them.

Developing sustainable finance principles. A draft document on Sustainable Finance Principles for financial institutions has been prepared and reviewed by IFC experts. The project defines sustainable finance principles in 4 blocks - business strategy, corporate governance, risk management and information disclosure. The sustainable finance principles are expected to be finalized and presented to financial institutions in Q1 2024.

Developing taxonomy for sustainable finance. The project team has studied the international experience to define the taxonomy model for Azerbaijan. In order to prepare the taxonomy in accordance with the country's sustainable development priorities and agenda, a group of experts from the Central Bank and ministries and government institutions responsible for energy, economy, ecology, finance and other related fields, as well as financial institutions, was formed. The Expert group held discussions on the formation of the taxonomy.

Fostering green and sustainable finance tools. In this regard, a draft amendment to the law on green bonds has been prepared and submitted to the government and is in the process of coordination with relevant state institutions. The draft defines the concept of a green bond, the purpose of its issuance, the green bond issuer and the main parameters of a green bond. At present, in parallel with the above-mentioned draft, the Central Bank is developing a corresponding draft regulation to define the scope of environmental projects and the criteria for such projects, the procedure for issuing green bonds, the use and management of the funds received from the placement of green bonds, as well as reporting and disclosure requirements and a number of other issues.

Making appropriate changes to the regulatory framework related to green lending. Thus, according to the changes made in the Central Bank's "Regulation on creation of special reserves for asset classification and loan loss provisioning" to stimulate the use of environmentally friendly vehicles, the high debt-to-income ratio (45%+) of the borrower for loans granted for the purchase of electric and hybrid cars that meet the relevant criteria for the year of production is exempted from the additional provisioning requirement. In addition, the project team is preparing a guidance document on green lending.

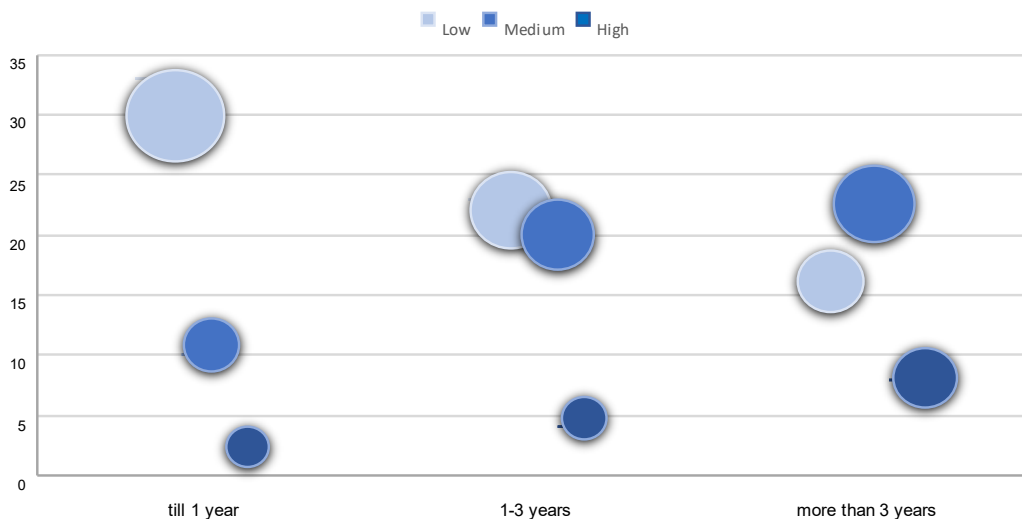
3.3. Climate-related and ESG risk assessment

Conducting climate-related and environmental risk assessment. A survey on sustainable finance was conducted to measure the awareness of financial institutions (banks, insurance companies and investment companies) on sustainable finance principles and ESG, to examine the actions taken and planned in this direction, and to collect

initial indicative data. The survey identified the importance of climate change and ESG factors for financial institutions, the plans to apply ESG principles, current market practices and the expectations of financial institutions. The survey results showed that financial institutions expect the impact of climate change and ESG risks increasing in the medium and long term (Graph 2).

In addition, the main expectations and proposals for the transformation of financial institutions towards sustainable finance and the application of ESG principles were in the direction of conducting awareness and information activities, preparing a legal-normative and regulatory framework, forming accountability and applying concessions on sustainable financial instruments. In general, the importance of ESG factors is relatively understood by financial institutions and environmental and social projects are implemented in a sparse manner. The results of the survey have been processed and published on the official website of the Central Bank in the Sustainable Finance section.

Graph 4. Expectations of financial institutions regarding climate change and ESG risk impacts (low, medium, high)



Note 1: The diameter of the circles in the graph visually reflects the number of financial institutions.

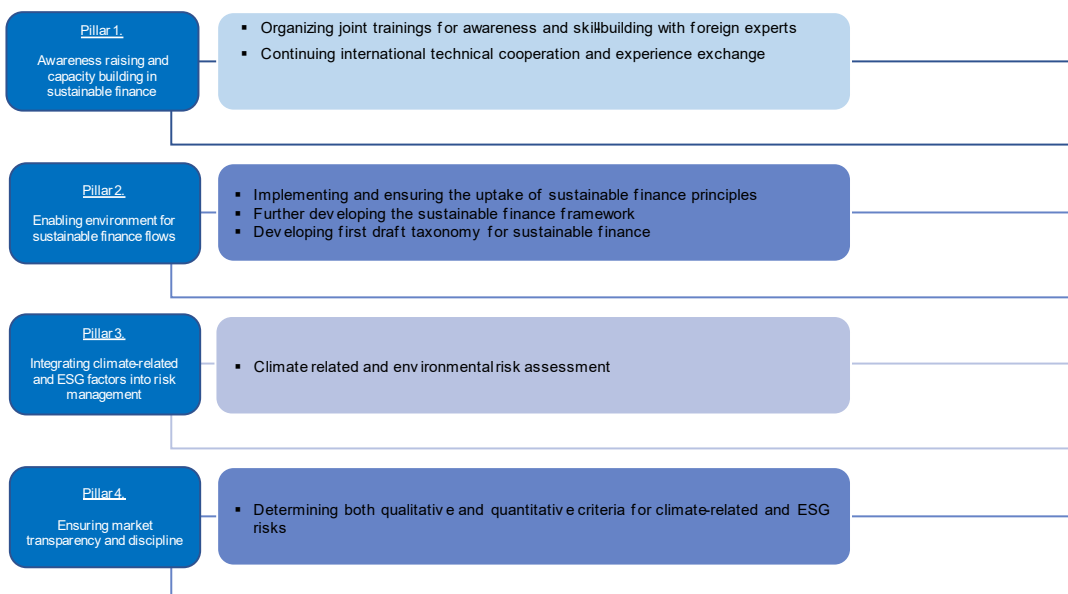
Note 2: The vertical axis indicates the number of financial institutions.

THIRD SECTION

4. Next Steps

The Central Bank will systematically implement adequate measures related to sustainable finance. Climate finance and sustainable finance is one of the most important tools for climate change mitigation and adaptation. In addition to ensuring adequate liquidity in financial markets, it is necessary to take appropriate steps to remove existing barriers to investment.

In this regard, the Central Bank will continue to take multifaceted and comprehensive measures to enhance the financial sector's potential for climate-related and ESG risk management and to create an enabling ecosystem for sustainable financial flows. These measures will be implemented taking into account international experience and local financial market conditions. The central bank aims to continue measures in the following directions in 2024:



Appendix 1. Azerbaijan: Current Climate-Related and Environmental Risks and Opportunities

The **physical risks relevant to Azerbaijan** are defined as follows³:

- a. Floods and droughts. The Central Aran and southeastern regions are prone to flooding, and regions on the southern slopes of the Greater Caucasus Mountains are prone to mudslides. In recent decades, the number and intensity of floods in small mountain rivers in the territory of Azerbaijan have increased. An increase in the probability of droughts is expected to affect agricultural productivity.
- b. Impacts on agriculture. Changes in temperature and precipitation will directly affect productivity and indirectly affect soil organic matter. This will have a cascading effect on food production. It should be noted that ~80% of the country's agricultural production is irrigated with rainwater.
- c. Vulnerability of coastal areas. According to 2015 calculations, 4 million people and 75% of the country's industrial centers are located in coastal areas. The expected decrease in the level of the Caspian Sea and the temperature rise will affect the economy of Baku in particular.
- d. Urban heat island effect. It is not excluded that the urban heat island effect, caused by the increase in urban population, will influence the temperature increase in an undesirable direction. This effect will be more pronounced in the summer months and will have a negative impact on the health of the population (which may lead to an increase in healthcare costs), productivity in the service sector and labor productivity.
- e. Caspian Sea level fluctuations - Caspian Sea level fluctuations in the context of climate change pose a serious threat to Caspian biodiversity and ecosystem.
- f. Water scarcity - Azerbaijan's freshwater resources are small and unevenly distributed. Approximately 70 percent of the country's freshwater resources are located outside its borders. The risk of water scarcity is expected to increase in the future. Lack of freshwater resources will have a negative impact on all environmental, social and economic sectors.
- g. Land degradation - One of the main current risks for Azerbaijan is land degradation. This problem is made more urgent by global climate change and the increasingly visible processes of desertification. Soil salinization and erosion seriously threaten agriculture and sustainable development.

The above-mentioned physical and transition risks for Azerbaijan call for appropriate measures to mitigate and adapt to them. While some potential "greening" measures can be implemented and achieved in the short term, others require complex and long-term implementation planning. For example, investments in resource efficiency (e.g., energy demand management, energy efficiency) and agricultural intensification, land use efficiency, urban planning, water and waste management are examples of investments that can yield quick returns. Investments that support the transition to competitive renewable energy sources, such as solar and wind, are examples of such measures. On the other hand, reforming measures that affect consumer and investor choices, such as carbon pricing and fuel and electricity subsidies, take longer to implement and cost more, while providing longer-term benefits.

Private sector investment in green, including social, projects will bring innovative solutions and efficiency, as well as multiple economic and social benefits. In order to channel private sector funds into green, including social,

³"Azerbaijan: towards green growth", WB, September 2022, Expert Opinion

investments, it is necessary to apply government support and incentive mechanisms, design green financial instruments and develop a taxonomy of sustainable finance.

The sustainable use of land and water for agriculture and forestry, as well as the sustainable use of other natural resources, will be important to ensure resilience to climate-related and environmental risks, as well as economic efficiency. The use of new technologies and innovative solutions is seen as a prerequisite for the transition to a low-carbon economy, as well as for measuring biodiversity, ecosystems, and their economic and social impacts. Employment growth will be positively affected by asset diversification and the creation of new employment opportunities in sectors with greening potential. Market-based and "smart" policy changes at all stages of the value chain, increased use of renewable energy sources and the transition to low-carbon production will accelerate the greening process.

The Caspian Sea basin, on the other hand, offers new opportunities and possibilities for green solutions. Although it will take time, opportunities such as developing sustainable tourism and aquaculture in the Caspian Sea, as well as using renewable energy in coastal areas, can play an important role in supporting the transition to a green economy. Azerbaijan's rich natural resources are well suited to support the transition to a low-carbon economy, a cleaner environment and green development. Channeling both private and public funds to decarbonization and diversification actions will support sustainable socio-economic development in the short term.