



# **Guidelines For Banks On Climate-Related And Environmental Risks**

## **Advisory Letter**

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## 1. General provisions

Risks related to climate change and environment are becoming more and more relevant for banks, and they need to be taken into account during risk management. The aforementioned risks need to be adapted to the bank's business strategy, risk-taking strategy and risk-taking appetite, taking care that the role and responsibility in managing these risks are fully transparent through all three lines of defense. The role of control functions, especially internal audit, is important, starting with understanding the importance and categories of risks associated with climate change and environment, assessing the quality of managing these risks within the integral system of internal management, etc.

Proceeding from the above, banks which operate in the banking sector of Kosovo should undertake timely and systematic activities in the management of the mentioned risks in the following areas:

- a) The bank's business model and strategy;
- b) The internal management system and the bank's risk appetite;
- c) An integral framework for risk management, including ICAAP<sup>1</sup>; and
- d) Policies, procedures and content of disclosures on climate-related and environmental risks.

The purpose of this Advisory Letter for banks on Climate-Related and Environmental Risks (hereinafter: the advisory letter) is to guide the banking sector in terms of determining, measuring, managing and controlling climate-related and environmental risks and disclosing data and information related to these risks, as well as the integration of the segment environmental sustainability in the bank's business activities.

This advisory letter defines the concept of safe and prudent management of climate-related and environmental risks in the existing legislative and regulatory framework, and the obligation of banks to identify risks associated with climate change and environment as drivers of existing risk categories when defining and implementing their business strategies, internal management and management systems risks. This advisory letter seeks to achieve greater transparency through the timely and adequate disclosure of information and data related to climate and environmental risks.

Banks are recommended to apply this advisory letter in accordance with the nature of their business model and the characteristics of the services they provide, including the specifics arising from the organizational structure, size and complexity of the bank, risk profile and extent of exposure to credit risk.

This advisory letter is addressed to banks subject to the Law Nr. 08/L-304 on Banks [hereinafter, “the Banking Law”].

Finally, it is important to note that this advisory letter is focused on climate-related and environmental risks, and not in the broader concept of environmental, social and governance (ESG).

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<sup>1</sup> And ILAAP when applicable.

## 2. Relevant definitions

For the purposes of this advisory letter, the following terms are used:

- a) **Environmental, social and governance (ESG)** risks represent the probability of losses or additional costs, or the loss of planned income, or the loss of the bank's reputation due to the negative financial impact of current or future ESG factors on other contractual parties and their property.
- b) **ESG factors** refer to environmental, social or governance matters that may have a positive or negative impact on the financial performance or solvency of an entity, sovereign or individual.
- c) **Climate-related and environmental risk-related strategic objectives and/or limits** are determinations which aim at managing a bank's exposure to climate-related and environmental risks, over the short-, medium- and long-term time horizons.
- d) **Climate-related risks** are the financial risks posed by the exposure of banks to counterparties that may potentially contribute to or be affected by climate change.
- e) **Transition risks** refer to the risks to banks arising from the transition to a low-carbon and climate resilient economy:
  - a. **Policy-regulatory risks**, for example those arising from energy efficiency requirements, carbon pricing mechanisms that increase the price of fossil fuels, or policies that promote sustainable land use.
  - b. **Technological risks**, for example when a technology with a less harmful impact on the climate replaces a technology with a more harmful impact on the climate.
  - c. **Market risks**, for example if consumer and corporate client preferences and demand shift towards less climate-damaging products and services.
- f) **Physical risks** are risks to banks arising from the physical effects of climate change:
  - a. **Acute physical risks** are sudden short and severe events that have a significant negative impact, arising from specific events, in particular weather-related events such as storms, floods, fires or heat waves, which can damage production facilities and disrupt value chains.
  - b. **Chronic physical risks** are those resulting from longer-term changes in climate, such as changes in temperature, rising sea levels, declining water resources, loss of biodiversity and changes in soil fertility.
- g) **Greenhouse gases (Green House Gases - GHG)** are gaseous components of the atmosphere, both natural and anthropogenic (related to humans), which absorb and emit radiation at certain wavelengths within the spectrum of thermal infrared radiation emitted by the Earth's surface itself atmosphere and clouds. This property causes the greenhouse effect. Water vapor (H<sub>2</sub>O), carbon dioxide (CO<sub>2</sub>), nitrogen oxide (N<sub>2</sub>O), methane (CH<sub>4</sub>) and ozone (O<sub>3</sub>) are the primary greenhouse gases in the Earth's atmosphere.
- h) **Green economy (low-carbon economy)** means an economy with low carbon emissions that uses resources efficiently and is in the public interest.
- i) **Green lending/investment (the broad term "green products")** refers to lending, investment or other financial products of the bank, which depend on ecological criteria for the planned use

of funds, with the aim of reducing the adverse effects of activities on the environment or risks to environment.

- j) **“Greenwashing”** refers to the practice of gaining an unfair competitive advantage on the market by advertising a financial product as environmentally acceptable, when in fact the basic environmental standards are not met.
- k) **Risk appetite** means the aggregate level of types of risk a bank is willing to assume within its risk capacity, in line with its business model, to achieve its strategic objectives.
- l) **Taxonomy** of economic activities means a classification system in which a list of ecologically sustainable economic activities and thresholds can be used to clearly determine which economic activity is in accordance with sustainable development, environmental goals and principles of sustainable economic activity. Such a taxonomy helps investors, issuers and project promoters to focus on the transition to a low-carbon and more resource-efficient, risk-resilient economy, as well as facilitates a climate-related information disclosure system. Since there is currently no taxonomy in force in the Republic of Kosovo, the bank will develop these definitions internally and apply them to the products it offers to its clients as necessary. For these purposes, the bank can use definitions from other international practices (e.g., Taxonomy of the European Union<sup>2</sup>). According to the principle of proportionality, the applicable taxonomy should be adequate to the nature, scope, size and business model of the bank.

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<sup>2</sup> <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=celex:32020R0852>

### 3. Supervisory expectations for business model and strategy

1. Climate-related and environmental risks may affect the business environment of banks. In accordance with the Regulations on Risk management, in the course of setting an adequate risk management system, the Central Bank expects banks to identify the risks arising from climate change and environmental degradation at the level of key sectors, geographical areas as well as in relation to products and services in which they operate or plan to operate, taking into account that some of these risks may materialize over a fairly medium to long period of time. Furthermore, as changes to the business model need some time to become operational, early and prompt action may be needed even in cases where vulnerabilities are identified only in the medium to long term.

Climate-related and environmental risks can affect, for example, economic growth, employment or property prices at national, regional or local level. Weather events can cause droughts or floods that affect a region's agricultural production, housing demand or the value of collateral at national, regional or local level. In parallel, competition is influenced by the development of a green financing market and consumer preferences that are shifting away from high carbon or otherwise polluting goods and services towards low carbon or otherwise “green” products and services. In the domain of technology, banks serving clients in energy-intensive industries and power plants that rely heavily on fossil fuels (i.e., coal-fired power plants) may see their clients face significant investment requirements to de-carbonize their energy mix. Thus, in identifying risks, a bank may categorize its clients or portfolios according to climate risk exposures. For example, geographic grouping can help to identify exposures that are exposed to high physical risks, such as high risk of flood or drought. Sectoral categorization can help to identify transition risks, for example by assessing the share of highly GHG-intensive sectors in the lending portfolio.

2. Climate-related and environmental risks can have a direct impact on the effectiveness of a bank's existing and future strategies. The Central Bank expects banks to identify and assess which climate-related and environmental risks are material to them in the short, medium and long term, and the resilience of their business strategy to these risks. The time horizon is particularly relevant, as most climate-related and environmental risks are expected to manifest themselves in the medium-to-long terms, usually going beyond the common banks' business planning cycles.
3. The CBK expects banks to adequately document the processes by which they assess the significance of climate-related and environmental risks to their business environment.
4. The CBK expects that the implementation of a bank's business strategy reflects the bank's consideration of significant climate change and environmental risks. The process will be more credible if banks define and monitor long-term key performance indicators (hereinafter: “KPIs”)<sup>3</sup>, that should be quantitative, when feasible. Depending on the nature, complexity and scale of the bank's activities, these indicators may be cascaded down across business lines, clients and products, where they are material and relevant.

Indicators that set a specific target for green or social loans may, for example, be cascaded down or broken down into corporate clients; individuals; business activities or economic sectors; types of loans (e.g., consumer loans, mortgages, credit lines, etc.); geographic situation; etc.

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<sup>3</sup> And/or key risk indicators (hereinafter: “KRIs”) or risk limits.

5. The CBK expects that banks also consider the impact that their business models and strategy development may have on the environment, for example through measuring and limiting the GHG emissions or resource efficiency of their main portfolios or that stem from their own activities. The CBK recommends that banks should take steps to mitigate the transition risks, for example by gradually or even rapidly reducing and phasing out financing of environmentally unsustainable activities. The CBK considers it to be a good practice for a bank to develop a carbon neutrality plan in line with the overall climate-related and environmentally sustainable objectives (i.e., those established nationally and internationally, including, but not limited to, the Paris Agreement, United Nations Framework Convention on Climate Change (UNFCCC), National Determined Contributions (NDC), etc.). These efforts are also in line with the objective of Article 2(1)(c) of the Paris Agreement<sup>4</sup>. Despite that the Republic of Kosovo is not a party to the United Nations Framework Convention on Climate Change and the Paris Agreement, showing its commitment with the objectives.

Climate-related and environmental risks are likely to affect different regions, economic (sub-sectors, types of borrowers and assets differently). In light of this, the banks' overall objectives and targets may need to be translated into more specific targets (or limits), including exclusion policies for certain regions, sub-sectors or activities (e.g., specific sectors or types of counterparties due to highly polluting production).

6. Finally, banks are also expected to strategically assess whether to develop sustainable products that are considered to be more resilient to climate-related and environmental risks. These include products typically marked as 'green'. Banks can use such products as a tool to implement their climate-related and environmental risk objectives and adjust their business models and portfolio composition. Banks that originate or plan to originate environmentally sustainable credit facilities should develop, as part of their credit risk policies and procedures, specific details of their environmentally sustainable lending policies and procedures, covering the granting and monitoring of such credit facilities. Banks should position their environmentally sustainable lending policies and procedures within the context of their overarching objectives, strategy and policy related to sustainable finance, and assess the extent to which the development of their environmentally sustainable lending activity is in line with, or is contributing to, their overall climate-related and environmental risks objectives and/or limits.

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<sup>4</sup> [https://treaties.un.org/doc/Treaties/2016/02/20160215%2006-03%20PM/Ch\\_XXVII-7-d.pdf](https://treaties.un.org/doc/Treaties/2016/02/20160215%2006-03%20PM/Ch_XXVII-7-d.pdf)

For the purposes of this advisory letter, climate-related and environmental strategic objectives and/or limits are understood as determinations which aim at managing a bank's exposure to climate-related and environmental risks, over the short-, medium- and long-term time horizons. For example, banks could set strategic objectives and/or limits regarding the proportion of their exposures to certain economic activities or sectors. In contrast, objectives or limits which do not relate to the resilience of the business model and whose purpose is not to effectively enhance the bank's management of climate-related and environmental risks are not considered climate-related and environmental strategic objectives and/or limits. Further, banks should bear in mind that setting strategic objectives will be likely to alter their overall risk profile, resulting in a need to review their risk appetite.

#### 4. Supervisory expectations for corporate governance

7. The Central Bank considers climate-related and environmental risks to be included in the corporate governance system in a bank set out in Article 2(1.1) of the Regulation on corporate governance of banks of the Central Bank of the Republic of Kosovo. Accordingly, the Board of Directors must have sufficient knowledge and understanding of climate-related and environmental risks to ensure that the level of risk assumed is consistent with the bank's risk appetite and risk strategy, internal procedures and policies, and that the bank complies with applicable legal requirements and other obligations.

For example, the Central Bank considers it to be a good practice if the Board of Directors receives regular reports on climate-related and environmental risks or is regularly informed about them under a dedicated agenda item at its meetings.

8. In the application of Article 9 (2) and 13 of the Regulation on Corporate Governance, the CBK expects the Board of Directors of the bank to have sound and objective judgments, possessing appropriate qualifications and competences, also with regard to climate-related and environmental risks. The CBK considers it to be a good practice for banks to require also key personnel to have expertise in climate-related and environmental risks relevant to the performance of their duties and for members of the Board of Directors and key personnel to be familiar with the climate-related and environmental risks of the bank as soon as at the start of their employment, as part of their onboarding and training for their duties.
9. Banks are expected to clearly delimitate the responsibilities of each function and individual person performing control functions with regard to climate-related and environmental risks, in line with the general principles on internal control system and control function in relation to the general responsibilities under Article 3 of the Regulation on internal controls and internal audit, and to clearly describe the mandate, work processes and objectives for these functions. It is the responsibility of the Board of Directors to ensure that the relevant responsibilities are clear, well defined, consistent, enforceable and adequately documented.
10. The CBK also expects that banks, when setting the internal duties and responsibilities for the management and control of climate-related and environmental risks, chose among one of the following options:
  - a) A separate organizational unit or function (e.g., a unit headed by a “chief sustainability officer”, part of the senior management of a bank) responsible for the management and control of climate change and environmental risks is established within the bank. Where the bank establishes a separate department or function for climate-related and environmental risks, it is expected that the integration of the separate department or function into existing processes and its relationship with other functions is clearly defined (division of responsibilities and duties, cooperation and reporting obligations, etc.).
  - b) A senior manager or a member of the management is designated responsible for the management and control of climate-related and environmental risks (for example, a key person in charge of an area with a control function other than the internal audit function), subject to an appropriate separation of duties and responsibilities.

11. The CBK expects banks to ensure that the functions involved in managing climate-related and environmental risks have adequate resources, both human and financial, and have sufficient stature and authority to fulfil their role effectively. The CBK also considers it to be good practice for banks to provide relevant training opportunities for their staff focused on climate-related and environmental risks and to consider the possibility of a general environmental and climate-related awareness training, in special to those performing control function activities.
12. In line with the general requirements of the Regulation on internal control and internal audit, the Board of Directors is expected to exercise effective oversight over the bank's exposure to climate-related and environmental risks and regarding the impact of the business strategy on climate and environmental sustainability objectives.
13. In order to take a comprehensive approach to risk, taking into account the long-term financial interests of the bank, it is recommended for the Board of Directors to develop the bank's response to the general climate-related and environmental risks, and sustainability objectives in the form of a climate-related and environmental risks strategy. In this sense, it is expected that banks integrate climate-related and environmental risks into their risk culture.
14. Remuneration policies and practices are expected to contribute to a long-term approach to addressing climate-related and environmental risks. The CBK considers it to be a good practice for banks to set indicators related to climate and sustainable finance in their remuneration policies., and those indicators to be embedded in the business strategy and/or risk management framework of banks.
15. Banks are expected to integrate both climate-related and environmental risks into their internal reporting systems, on their risk exposures and risk profile so as to provide all relevant levels of management in the bank with reliable, complete, object and timely information necessary for making business and risk decisions. The CBK is aware that the relevant metrics and tools are evolving and that the available data at banks is likely to be incomplete at present. Nevertheless, it expects that reporting on climate-related and environmental risks will improve over time. In the short term, the CBK expects banks to assess their data requirements from their strategy development and risk management units, identify data gaps, and outline plans to address them and overcome any shortcomings.
16. The internal control system of the bank is expected to ensure that the bank has effective and reliable internal and external data reporting, disclosure and communication systems that are capable of aggregating climate-related and environmental risks data.

Given the nature of climate-related and environmental risks, the CBK recommends that banks should assess the need to adapt their information systems to be able to collect and aggregate the necessary data to assess their exposure to these risks. The CBK expects banks to build a data taxonomy of these risks. Where this is not feasible due to lack of common definitions, incomplete taxonomies and data gaps, the CBK considers it to be a good practice for banks to consider developing processes and procedures based on internal or even external rating risk metrics. In this case, it is expected that the Board of Directors is aware of the limitations of the data and information produced by the information systems.

## 5. Supervisory expectations for risk management

### 5.1. Risk management system

17. The CBK expects banks to have a comprehensive and well-documented picture of the impact of climate-related and environmental risks on existing risk categories. Climate-related and environmental risks may be considered as factors affecting existing risk categories, but banks may treat these risks as a separate risk category for organizational or analytical purposes.

For example, extreme weather events (e.g., drought) may be considered as a factor affecting credit risk (as an existing category) in agricultural lending, whereas other physical risks (i.e., floods) may influence several risk categories simultaneously (i.e., credit risk, operational risk, liquidity risk).

Nevertheless, banks may treat them as part of a separate stand-alone risk category called “ESG”, “climate” or other.

18. It is recommended for banks to take steps to quantify climate-related and environmental risks. Banks shall make proportional efforts to use quantitative indicators for this quantification, seeking to put any remediation actions to the data shortcomings they may face.
19. The CBK expects that banks consider the need to review their risk management policy (i.e., Risk Policy) and other internal acts defining in detail the functions, systems, processes, procedures, activities and methodologies, as well as competencies, responsibilities (collective and individual) and reporting lines at all levels of the bank's organizational structure, in light of climate-related and environmental risks.
20. When reviewing their risk appetite, banks are expected to develop appropriate risk indicators and set appropriate limits for climate-related and environmental risks. Banks are also expected to monitor and disclose, where available, its policies for economic sectors, geographical exposures, current data on climate-related and environmental risk exposures, preferably in the form of quantitative measures, based on a combination of historical data and forward-looking estimates, in accordance with the requirements in section 6.

The CBK acknowledges this as a progressive process and that, until banks develop appropriate numerical measures or until common measures are available, non-numerical findings may be also used.

### 5.2. Credit risk management

21. In line with the requirements set out in Article 3 of the Regulation on credit risk management, the Central Bank expects banks to develop specific details of their environmentally sustainable credit risk policy and credit strategy of the bank. The CBK expects that banks set out their environmentally sustainable policies and procedures on exposure approval in line with their overall objectives, strategy and policy on sustainable finance. Defining environmental sustainability lending requires the development of new internal set of criteria or the incorporation of existing or forthcoming standards into the credit risk policy and credit strategy.
22. The CBK expects banks to consider climate-related and environmental risks at all relevant stages of credit risk/exposure approval and credit risk management.

23. For large corporate clients, the bank is expected to have an updated view on: (i) the sustainability of the client, (ii) the exposure of the client to the physical and transition risks and (iii) the climate change mitigation plans for the client (i.e., the plans for the client to align with Republic of Kosovo's commitments). Banks may incorporate into their credit risk ratings these aspects, to broaden its understanding on the impact that the alignment of a client with climate-related and environmental factors may have in its credit risk.
24. In addition to credit risk/exposure approval, the bank is expected to understand the use of the loan, and particularly, if the loan is being used for funding sustainable or unsustainable activities, in accordance with the criteria defined by the bank as part of its environmentally sustainable credit risk policy. Banks should request this information directly from their clients and update it regularly. Furthermore, the process of credit risk management also requires procedures and methodologies through which banks can verify that the loan has in fact been used to finance sustainable activities, which should include the following:
- a) Collecting information about the climate-related and environmental or otherwise sustainable business objectives of the borrowers.
  - b) Assessing the conformity of the borrowers' funding projects with the qualifying environmentally sustainable projects or activities and related criteria.
  - c) Ensuring that the borrowers have the willingness and capacity to appropriately monitor and report the allocation of the proceeds towards the qualifying environmentally sustainable projects or activities.
25. For loans to other legal entities, banks are expected to request information on the use of their loans before its approval and assessing whether the loan is being used for qualifying environmentally sustainable economic activities or, at least, that the loan is not being employed to fund non-qualifying sustainable economic activities that have been restricted or limited in accordance with the bank's risk appetite or the bank's internal credit policies. The bank is also expected to consider the exposure to physical and transition risks for clients based in regions or operating in sectors that the bank considers to be particularly vulnerable to these risks.
26. For loans to individuals, the bank will be expected to ensure that, when a "sustainable product" is defined (e.g., "green loans") that the loan features are consistent with the definition of the product and that the funds have been deployed accordingly. Banks will be expected also to assess the exposure to physical risks of clients that are assessed to be particularly expose to physical risk (i.e., those living in areas at high risk of flooding).
27. Banks are expected to assess the impact of climate-related and environmental risks on the borrower's probability of default (PD), the value of the exposure at default (EAD) in the event of default and the average loss given default (LGD). As part of this assessment, it is recommended that banks consider the quality of climate-related and environmental risk management of their own clients, as well as changes in the risk profile of sectors and geographies driven by climate-related and environmental risks. In cases where the bank is not able to determine the value of either the LGD or the EAD parameters using its model in an adequate and documented manner, the bank shall follow the standardized percentages provided by the Central Bank of the Republic of Kosovo.

With regard to credit risk, climate-related and environmental risks may challenge banks in all stages of the process, from granting to monitoring. Specifically, climate-related and environmental risks can impact the main credit parameters:

- a) PD: an increase in the PD of vulnerable counterparties can be triggered, for instance, by a shift in social norms that reduces the demand for certain products and increases downward pressure on revenues, or the impact of severe weather conditions, such as drought, pushing agricultural business into default.
- b) EAD: counterparties subject to physical risk might need to draw more from their committed credit lines to respond to sudden shocks, like floods.
- c) LGD: in a transition scenario, the value of stranded assets will decrease, determining lower collateral values and, in a default scenario, lower recovery values.

28. Banks are expected to conduct climate-related and environmental risks assessment on their clients both before and after approval of risk. The CBK considers it to be a good practice if this includes the collection and verification of information and data necessary to assess the vulnerability of borrowers to climate-related and environmental risks, in particular before entering into a credit agreement or a significant modification thereof, in line with the bank's onboarding policies and procedures, and following the principle of proportionality and considering the nature of the client and its activities. Banks are expected to understand the impact their clients have on climate change and on the environment, as well as their vulnerability from them. Furthermore, banks should be aware of their clients' attitudes to managing these impacts and risks.

For example, banks may consider using analytical tools that highlight the climate-related and environmental risks of each economic (sub)sectors on a graph or scale. For loans or borrowers with higher climate-related and environmental risks a more comprehensive analysis of the borrower's business model is required, including a review of current and projected GHG emissions, the market environment, regulatory environmental requirements, an analysis of the likely impact of regulation concerning the environmental aspects on the borrower's financial position.

29. Banks are expected to take climate-related and environmental risks into account when assessing collateral, as they may affect the value of the collateral.

For example, in this respect, it is recommended for banks to take into account the location of the commercial or residential property, its technical and energy characteristics, the efficiency of the mechanical engineering systems, etc.

30. It is expected that the bank's credit pricing framework reflects climate-related and environmental risks and those are reflected in its credit risk appetite (i.e., by specifying risk limits, tolerances and thresholds) and business strategy too.

For example, as part of defining its business strategy and risk appetite, banks may choose to reduce or limit their exposures to sectors that are harmful to the environment or climate, while increasing their exposures to sectors that have a positive impact on the environment or climate.

Thus, the pricing framework is expected to support the chosen risk perspective and strategy, for example by differentiating the price of loans according to the energy efficiency of the exposures or by applying sector- or client-specific fees.

In line with their business strategy and risk appetite, banks may also consider encouraging their clients to take due account of climate-related and environmental risks in order to improve creditworthiness and resilience to such risks. This may involve, for example, that banks offer a reduced interest rate on an environmentally sustainable loan or linking the interest rate of the loan to a sustainability target to be achieved by the client that contributes to or is consistent with the overall climate change-related and environmentally sustainable goals.

In the definition of its credit risk appetite, the CBK expects banks to assign quantitative metrics to climate-related and environmental risks, particularly for physical and transition risks. However, the Central Bank also acknowledges that common definitions in these risk areas need time to be more mature in the sector, and that qualitative statements can be used as intermediate steps while the banking sector develops appropriate quantitative metrics. It is also expected that the relevant risk appetite indicators and limits are determined based on the level of risk that the bank is willing to assume within its risk profile, in line with its business model.

31. The Central Bank expects banks to monitor and manage climate-related and environmental risks in their credit portfolios with the general requirements of the Regulation on Credit Risk Management in mind, for example through concentration analysis and stress testing.

### **5.3. Operational risk management**

32. The CBK expects that banks assess the impact of physical risks arising from climate change on their own operations, including their ability to quickly restore their capacity to continue providing services. The geographical location in which a bank operates may make it more susceptible to physical risks. This is particularly relevant for outsourced services and IT activities, especially if service providers are located in locations with a higher risk of extreme weather events or other environmental vulnerabilities.
33. In particular, when assessing critical functions, it is recommended for banks to consider the impact of climate change on the provision of such services. Where the outcome of that assessment is material to any business line or the overall operations of the bank, it is recommended to be reflected in the bank's business continuity plan.
34. In a broader view, the CBK expects banks to consider the extent to which the nature of the activities it carries out increases the future risk of reputational damage. In order to avoid legal and reputational risks related to environmental and climate risks, banks are expected to assess whether their investment products comply with international best practices. For instance, a bank that is involved in financing activities that are publicly controversial (e.g., fossil fuel financing, financing a company that has been accused of breaking child or forced labor rules, etc.) might see their reputation impacted or might be subject to legal claims.

35. Additionally, the CBK considers it important that banks strive to reduce their own ecological and carbon footprints, as insufficient knowledge of these or failure to reduce them effectively, in addition to preventing constructive contributions to the efforts required by international agreements, also entail reputational risks. The CBK therefore considers it to be a good practice for banks to operate an environmental management system that complies with internationally accepted standards, and to measure and seek to continuously improve their environmental performance:

- a) As regards the GHG emissions, the CBK proposes the following:
  - i. Measuring direct emissions from own activities (Scope 1)<sup>5</sup>.
  - ii. Measuring indirect emissions related to purchased energy (Scope 2).
  - iii. Measuring other indirect emissions (Scope 3), with the financed emissions primarily related to credit and market risk management rather than to operational risk management.
- b) As regards other environmental impacts of operations and measures to reduce them, the CBK recommends the following:
  - i. Introduction and promotion the use of cashless payment methods.
  - ii. Reduction in the use of paper for client and/or product contracting promoting the use of digital media.
  - iii. Other initiatives related to own operations, along the validated environmental performance indicators.
- c) As regards the ecological footprint, the CBK proposes the following:
  - i. Reducing the use of paper and water both in bank's headquarters and branches.
  - ii. Promoting the teleworking in order to reduce staff mobility and, thus, the use of cars and other means of transport.
  - iii. Ensuring long-term contracts with electricity suppliers ensuring energy renewable sources.
  - iv. Other ways that may either ensure the reduction of the ecological footprint or may contribute to its fight.

36. In line with the requirements of section 6, the CBK considers it to be a good practice to publish the progress on the steps taken related to the above-mentioned proposals in the context of sustainability or integrated reports prepared according to an internationally accepted standard.

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<sup>5</sup> Detailed information on the scopes is available in the GHG Protocol standards: <https://ghgprotocol.org/>

#### 5.4. Market risk management

37. Regarding the management of market risk, the Central Bank expects banks to take into account that environmental and climate risks may lead to shifts in the supply and demand of financial instruments (e.g., securities, derivatives), products and services, which may affect their value.
38. A bank that invests in companies with business models that are assessed as environmentally unsustainable, located in geographical areas exposed to physical risks may suffer a decline in the value of its investments as a result of policy measures, changes in market sentiment or technology, or as a result of gradual adverse changes in severe weather events or climatic conditions.
39. This is relevant when financial instruments issued by companies in sectors that are assessed as environmentally unsustainable or that do not apply a comprehensive sustainable governance approach suffer a sudden drop in value.

#### 5.5. Liquidity and funding risk management

40. In connection with the general requirements of Article 17 of the Regulation dated February 28, 2023, "Regulation on the bank liquidity risk management" (hereinafter "the Regulation on Liquidity Risk Management"), the Central Bank expects banks to consider whether climate-related and environmental risks impact their liquidity or funding position. Where these risks are considered material, it is recommended that the bank takes steps to identify, measure, manage and monitor the impact of climate-related and environmental risks impact in its liquidity and funding position over appropriate time horizons and to maintain adequate liquidity buffers, within the framework of the legislation on liquidity risk measurement and management.
41. The previous assessment is expected to be conducted in a forward-looking manner, assuming both business-as-usual and stressed conditions, and, in particular, to consider severe but plausible scenarios that may occur in combination, with a focus on key vulnerabilities. Consequently, they are expected to assess whether climate-related and environmental risks could have a material impact on bank's liquidity or funding position.

On the one hand, climate and environmental factors can influence the value of financial assets, which in turn might affect the capacity to trade that asset, thereby creating short-term liquidity risk. This risk can also arise as the result of climate or environmental events triggering a deposit run on the bank: environmental crises, such as social unrest, can lead to higher withdrawals or put stress on the liquidity position of the bank in a specific geographical area.

On the other hand, climate and environmental factors can affect the availability and/or stability of funding (e.g., hampered or more expensive access to market funding, unstable deposits due to changing customer preferences, etc.), thereby creating medium- or long-term funding risk. In this context it is important to acknowledge the potential effect of reputational issues on the funding of banks.

#### 5.6. Scenario analysis and stress testing

42. Banks are recommended to assess climate-related and environmental risks through the use of scenario analysis and / or stress testing. In this sense, it shall be highlighted that unlike traditional stress tests, the most dramatic impacts of climate-related or environmental risks are likely to

happen in the medium to long term, and therefore a considerably longer time horizon will be required for these exercises.

43. As regards climate-related and environmental risks, it is recommended for banks to consider the use of scenarios that are consistent with scientific climate change trajectories, such as the Intergovernmental Panel on Climate Change (IPCC) scenarios. The CBK expects banks to take into account at least the following aspects when conducting sensitivity, scenario analysis and stress testing as regards climate-related and environmental risks:
  - a) How physical and transition risk may affect the bank.
  - b) How climate-related and environmental risks might evolve under different scenarios, taking into account the features of this type of risk (uncertainty and non-linearity, probability that cannot be based on historical data, potentially extreme and widespread impacts).
  - c) How climate-related and environmental risks may occur in the short, medium and long term, depending on the scenarios considered.
44. The CBK expects banks to define their own risk profile and assumptions regarding its specific features, and it is also recommended considering several scenarios based on different combinations of assumptions. It is expected that as part of their capital planning, banks assess their capital adequacy against a credible baseline and bank-specific adverse scenarios. As regards adverse scenarios, the CBK recommends banks to assume exceptional but plausible events of sufficient severity in terms of their impact on capital adequacy.
45. The CBK considers it necessary for the banks to interpret the results of stress tests and, if necessary, to take clear risk mitigation measures based on them. The CBK expects that stress testing programs are communicated effectively across all relevant business lines and at senior management level in order to raise risk awareness, improve risk culture and facilitate dialogue within the organization on possible risk management measures.

## 6. Supervisory expectations for disclosures

46. In relation to the disclosure obligations regarding climate-related and environmental risks, the CBK expects that the information disclosure policy approved by the Board of Directors of a bank specifies how the bank assesses the materiality of the information related to climate change and environmental risk for its disclosure to the public.
47. Where a bank does not consider climate-related and environmental risks to be material and, thus, omit its disclosure, the CBK expects the bank to document this decision with qualitative and quantitative information supporting the assessment.
48. When a bank discloses data, metrics and targets that are considered material to climate-related and environmental risks, the Central Bank expects it to disclose or refer to the methods, definitions and criteria related to them.
49. The Central Bank recommends banks, following a principle of proportionality, to take steps to be able to disclose the total GHG emissions it finances in addition to its own GHG emissions. The Central Bank considers it to be a good practice for banks to adopt a sufficiently detailed approach to measuring and disclosing GHG emissions.

This may, for example, require a project-by-project approach to measuring the carbon intensity of large corporate portfolios, as well as a property-by-property measurement of actual energy consumption or an energy efficiency rating of property portfolios.

50. The CBK encourages all banks to contribute to the achievement of overall climate change and environmentally sustainable objectives. If a bank commits to contribute to climate change related or environmental objectives, it is expected to provide a comprehensive overview of the impact of the bank as a whole, providing comprehensive and meaningful information on how it contributes to the former objectives, in order to avoid greenwashing risk<sup>6</sup>.

For example, in the case of a bank committed to discontinuing or restricting the financing of certain industries or activities, the precise definition of the activity and the related objectives, time frames and extent of outstanding exposures must be disclosed. It is also important for the bank to communicate the progress it made towards achieving these objectives, the internal monitoring processes and relevant methodological considerations, in particular the criteria for identifying the counterparties covered by the funding policy and the size of the business relationships involved. Likewise, when reporting on its contribution to environmental objectives, it is appropriate for the bank to take into account all business lines and the entirety of its exposures.

51. Given the rapidly evolving climate-related and environmental risk disclosure frameworks and the needs of market actors in this area, it is recommended that disclosures are actively developed on an ongoing basis.

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<sup>6</sup> “Greenwashing” refers to the practice of gaining an unfair competitive advantage in the market by marketing a financial product as environmentally friendly, when in fact basic environmental standards have not been met.

## 7. Date of application

52. The expectations of the CBK outlined in this advisory letter are applicable as of its date of publication. Banks with activity in the Republic of Kosovo are expected to consider the extent to which their current management and disclosure practices for climate-related and environmental risks are sound, effective and comprehensive in the light of the expectations set out in this advisory letter. Where this is needed, banks are expected to promptly start enhancing their practices.
53. As part of the supervisory dialogue, banks are asked to inform the Central Bank of the following:
- a) By September 2026, any existing divergences in their practices from the supervisory expectations described in this advisory letter (the “self-assessment”). For doing so, banks shall follow the template and instructions provided in Annex 1 to this advisory letter.
  - b) By September 2026, arrangements aimed at progressively addressing these expectations (the “action plan”). For doing so, banks shall follow the template and instructions provided in Annex 2 to this advisory letter.
  - c) By March 2027, a follow-up of the status of the action plan from the previous paragraph (the “action plan follow-up”). For doing so, banks shall follow the template and instructions provided in Annex 3 to this advisory letter.

The CBK acknowledges that the management and disclosure of climate-related and environmental risks, and also the methodologies and tools used to address them, need to be evolved and are expected to mature over time.

**Annex 1. Self-assessment: template and instructions**

54. This Annex provides banks with both a standardized template and instructions that banks shall follow to report the CBK with the information on any existing divergences in the bank’s practices from the supervisory expectations described in this advisory letter, as described in paragraph 53.a):

Section	Subsection	Description of bank's status	Bank's compliance status	Additional comments	# deficiency
<b>3. Supervisory expectations for business model and strategy</b>	-				
<b>4. Supervisory expectations for corporate governance</b>	-				
<b>5. Supervisory expectations for risk management</b>	<b>5.1. Risk management system</b>				
	<b>5.2. Credit risk management</b>				
	<b>5.3. Operational risk management</b>				
	<b>5.4. Market risk management</b>				
	<b>5.5. Liquidity and funding risk management</b>				
	<b>5.6. Scenario analysis and stress testing</b>				
<b>6. Supervisory expectations for disclosures</b>	-				

55. When completing the table above, banks shall consider the following definitions for the information requested:

- **Section:** It makes reference to sections 3 to 6 from the CBK's advisory letter / recommendations on climate-related and environmental risks. Not to be modified by banks.

- **Subsection:** The section makes reference, when applicable, to subsections of sections 3 to 6 above from the CBK's advisory letter / recommendations on climate-related and environmental risks. Not to be modified by banks.
- **Description of bank's status:** Banks are expected to include here a description of the current situation of the bank in relation to the compliance (on non-compliance), as well as any specific plan to be implemented in order to meet the recommendations set in each specific section or subsection as described in CBK's advisory letter on climate-related and environmental risks.
- **Bank's compliance status:** A 3-level scale where banks are expected to show, in their opinion, their level of compliance in each specific section or subsection:
  - Compliant: the bank fully meets the expectations set in the CBK's advisory letter regarding the specific section or subsection, or there are few low-relevant aspects to be improved and action plans are in force for the bank to be compliant in a very short period of time.
  - Weak: the bank partially meets the expectations set in the CBK's advisory letter regarding a specific section or subsection, or the bank does not meet any of the expectations or recommendations and has in place action plans to meet them.
  - Non-compliant: the bank does not meet any of the expectations set in the CBK's advisory letter regarding a specific section or subsection, and there is no action plan in force for the bank to be compliant or partially compliant in a very short period of time.

Banks shall take into account that they will be expected to develop and implement actions for each of the deficiencies identified in this self-assessment".

- **Additional comments:** Any additional comment the bank may considered relevant to note regarding their status, actions to be implemented, any plan already under development or implementation, etc.
- **Deficiency:** A numerical identifier (i.e., 1, 2, 3, etc.) associated to a given deficiency that banks are expected to associate to a given deficiency. Different numerical identifier is expected to be associated to different deficiencies.

**Annex 2. Action plan: template and instructions**

56. This Annex provides banks with both a standardized template and instructions that banks shall follow to report the CBK with the arrangements aimed at progressively addressing the divergences with the expectations laid out in this advisory letter, as described in paragraph 53.b):

# Action to be implemented	Description of the action to be implemented	Related deficiency(ies)	Complexity	Potential barriers	Expected deadline to be fully implemented	Implementation goals for the 1st year	Implementation goals for the 2nd year <sup>7</sup>	Implementation goals for >2 years <sup>8</sup>
...								

57. When completing the table above, banks shall consider the following definitions for the information requested:

- **Action to be implemented:** A numerical identifier (i.e., 1, 2, 3, etc.) associated to a given action to be implemented by the bank in order to meet (either in the short or medium to long term) the recommendations from the CBK’s advisory letter on climate-related and environmental risks. Different numerical identifiers are expected to be associated to different actions in order to be able to follow-up the evolution of actions along the annual reporting of the status by each bank to de CBK. Banks need to take into account that more than one action plans may be associated to a single deficiency identified in the previous self-assessment.

<sup>7</sup> Only applicable in case the proposed action implementing time is longer than the referred timeframe.

<sup>8</sup> Only applicable in case the proposed action implementing time is longer than the referred timeframe.

- **Description of the action to be implemented:** Banks are expected to include here a description of the action plan to be implemented to be compliant with the recommendations set in each specific section or subsection as described in CBK's advisory letter on climate-related and environmental risks. Reference to areas involved, externalities, etc., are expected to be included by banks in the description.
- **Related deficiency(ies):** Banks shall here include the identification number of all the deficiencies ("# deficiency") that a given action plan is expected to help to "fix". Banks may take into account that one action plan may be related (or be impacting) one or more deficiencies; and one or more deficiencies may be associated with a given action plan.
- **Complexity:** A 3-level scale where banks are expected to show, in their opinion, the level of complexity of a given action to be implemented, following the below scale:
  - **Low:** the bank expects the action to be implemented in a short period of time; a low volume of resources (i.e., staff, money, etc.) are to be dedicated for its implementation; and/or no critical decision needs to be taken at Board or Shareholders' meeting level.
  - **Medium:** those cases not considered to be of a low nor high complexity.
  - **High:** the bank expects the action not to be implemented in a short or medium period of time; a high volume of resources (i.e., staff, money, etc.) are to be dedicated for its implementation; and/or critical decisions needs to be taken at Board or Shareholders' meeting level.
- **Potential barriers:** Banks are expected to enumerate and briefly explain any potential barrier that might delay the implementation of the action. Banks shall also include any potential mitigation measures the bank is about to define or implement.
- **Expected deadline to be fully implemented:** Bank's expected deadline for a specific plan to be fully implemented. When reporting time frames instead of specific dates, banks are expected not to report time frames longer than 3 months (i.e., 1st quarter of 2025 may be considered valid).
- **Implementation goals for the 1st year:** Banks are expected to include here subdivisions of the global action plan that are expected to be implemented in the 12 months following the reporting date.
- **Implementation goals for the 2nd year:** In those cases where the implementation time is expected to last for more than 12 months, banks are expected to include here subdivisions of the global action plan that are expected to be implemented between 12 and 24 months following the reporting date.

- **Implementation goals for >2 years:** In those cases where the implementation time is expected to last for more than 24 months, banks are expected to include here subdivisions of the global action plan that are expected to be implemented starting from 24 months following the reporting date.

### Annex 3. Action plan follow-up: template and instructions

58. This Annex provides banks with both a standardized template and instructions that banks shall follow to report the CBK with a follow-up of the status of the action plan described in paragraph 53.c) from this advisory letter:

# Action to be implemented	Implementation status (%)	Any changes made to the initial expected deadline to be fully implemented	Description of advances since the previous reporting status	Next steps to be implemented in the following 12 months	Additional comments
...					

59. When completing the table above, banks shall consider the following definitions for the information requested:

- **# Action to be implemented:** A numerical identifier (i.e., 1, 2, 3, etc.) associated to a given action to be implemented by the bank in order to meet (either in the short or medium to long term) the recommendations from the CBK’s advisory letter on climate-related and environmental risks. Different numerical identifiers are expected to be associated to different actions in order to be able to follow-up the evolution of actions along the annual reporting of the status by each bank to de CBK. Banks need to take into account that more than one action plans may be associated to a single deficiency identified in the previous self-assessment.
- **Implementation status (%):** An estimation from the bank, of the time consumed, more granular sub-actions put in place, etc., over the total implementation needs for the action to be fully implemented. Values shall range between 0% and 100%.

- **Any changes made to the initial expected deadline to be fully implemented:** Banks are expected to point out here any change made (i.e., delays or advances) to the initially defined deadlines for the implementation of the specific action. An assessment on how any delay or advance may impact to overall completion of the action is also expected to be included.
- **Description of advances since the previous reporting status:** Banks are expected to include here any advance related to the implementation of the specific action since the previous status reporting. Banks shall include mentions, at least, on the "next steps to be implemented in the following 12 months" reported for the same activity in the previous action plan follow-up, or in the "implementation goals for the 1st year" category in case this is the first time that the bank submits the action plan follow-up.
- **Next steps to be implemented in the following 12 months:** Banks are expected to include here subdivisions of the global action plan that are expected to be implemented in the 12 months following the reporting date.
- **Additional comments:** Any additional comment the bank may considered relevant to note regarding the status of the implementation of the action plan, any potential barrier, meeting deadlines, modifications to the initial definition of a given action, etc.