

Climate Risks in Albania and their Relevance to the Central Bank



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Climate change has far-reaching impacts, both in breadth and magnitude that are starting to affect the economy and society in Albania. Mitigating them and positioning the Albanian economy on a sustainable path requires important structural transformations and investments. The Bank of Albania (BoA) has a role to play in this process, both as a monetary policy maker and as a financial supervisor. This policy brief discusses the economic and financial consequences of climate change in Albania as well as the policy options available to the BoA to address them. It suggests a possible roadmap for the central bank in this context.

Introduction

Climate change already has a growing impact on businesses and households in Albania. In the next decades, it will impact all economic sectors and all regions in one form or another and is very likely to have irreversible consequences. To mitigate these impacts, profound changes in the Albanian economy are necessary, involving significant investments in transition and mitigation activities and infrastructures. These investments present both risks and opportunities for the Albanian economy and can only be unlocked by the coordination of public and private financial institutions, including the Bank of Albania (BoA). The BoA can play a role part both as financial supervisor and as monetary policymaker. First, the BoA must ensure the financial system's resilience to climate shocks. It can also contribute to creating adequate financial market structures and conditions for Albanian financial institutions to fund the opportunities of the transition to a net-zero economy. Second, the BoA must assess and manage its own exposure to climate risks, resulting from the assets it owns from monetary policy operations. This policy brief outlines a possible roadmap for the BoA to address all these challenges.

Climate economic and financial risks and opportunities in Albania

The transition to a net-zero economy and the impacts of climate change pose two types of risks for the Albanian economy and for its financial system: physical and transition risks. The materialization of these risks can have significant socio-economic consequences for Albanian firms and households, possibly resulting in financial impacts that can affect the soundness of financial institutions and the financial system. In this section, we present a preliminary assessment of climate risks in Albania and their consequences for financial institutions.

Albania is particularly vulnerable to *physical risks* such as floods, droughts, heat waves, and wildfires, according to the World Bank report of 2021. The coastal zones, the agricultural and energy sectors, and water resources are particularly at risk. Albania is already experiencing the effects of climate change with increasing temperatures and declining precipitation levels. These trends are expected to continue, leading to more frequent and acute weather events that can exacerbate other socio-economic risks.

Transition risks are also material. Albanian authorities have committed to transitioning to a sustainable economy and have taken significant steps in this direction, including signing the 2030 UN SDGs, the Paris Agreement and the Western Balkan Green Agenda outlined during the 2020 Sophia Summit. The country has also established a National Energy and Climate Plan and several other plans and frameworks to support the transition. However, challenges in terms of financial and institutional capacity remain on the path of this transition.

The transition to a net-zero economy requires major transformations across all sectors of the Albanian economy, in particular in the energy and transport sectors. This transition presents both risks and opportunities: it generates potential economic difficulties for businesses relying on fossil-fuel consumption but it represents new growth opportunities for emerging sustainable economic activities. This is also true for the financial sector.

On the one hand, financial institutions are exposed to both physical and transition risks. Extreme weather events (particularly floods and droughts) and changes in temperature and precipitation can impact the financial capacities of Albanian firms and households, potentially resulting in losses for banks. Similarly, firms and households involved in economic activities about to disappear with the transition will also see their financial situation worsen, potentially affecting the banks they do business with. It is crucial for financial institutions to assess these risks, implement risk management measures, and communicate them effectively to financial authorities and investors. This is particularly important since around 40% of Albanian banks' loan portfolios are estimated to be directed to transition-sensitive sectors such as manufacturing and construction.

On the other hand, financial institutions can also benefit from working with customers in economic activities that will grow with the transition. The EU Green Deal and the Green Agenda for the Western Balkans present opportunities for green financing and inclusive growth in Albania. The financial sector can play a key role in promoting sustainability, together with mitigating climate risks, by providing green loans, exerting stewardship over corporates, and exploring partnerships with private sector actors. The transition to a more sustainable economy is a challenge, but also a unique opportunity for the Albanian financial sector to support inclusive and sustainable growth and moving early in the transition is crucial for capturing these opportunities. The Albanian banking sector has already started supporting the transition by financing green projects, but further action is needed to ensure its stability and resilience to climate risks.

Climate policy framework in Albania

The Government of Albania has taken steps to address the challenges posed by climate change and enhance resilience to its impacts. At the global level, in 2016, Albania committed to the 2030 UN SDGs and to meeting NDCs under the Paris Agreement. It has since updated its NDCs, demonstrating increased ambitions and efforts to address climate challenges. The Albanian government is also aligned with the SDGs and has integrated its NDCs into its national adaptation plan processes and policy frameworks.

Sustainable finance is key in mobilizing the financial resources for transition and mitigation investments. Sustainable finance is still very new in Albanian financial markets. Policy awareness on green finance is however growing among local authorities and the Albanian financial sector has started to acknowledge the importance of assessing and addressing climate-related financial risks to be resilient, support climate transition, and better inform market participants. Leading Albanian banks have begun integrating environmental factors in their business operations. There is a growing interest in climate change and environmental issues at the management and board level in Albanian banks.

As a public institution, the BoA is working hard to address the implications of climate change, especially those for the financial system, in line with its mandate to safeguard financial stability. The BoA is still in a capacity building and explorative phase but it has started to focus on green finance and is committed to putting in place a multi-year strategy for the management and supervision of climate-related financial risks in the financial sector for 2023-2025 by the first quarter of 2023. The BoA is actively participating in various national, regional and international fora's to better assess and manage the economic and financial impact of climate change. This includes, inter alia, its membership to the Network for Greening the Financial System (NGFS) since 2020, its collaboration with the Swiss State Secretariat for Economic Affairs, with the Vienna Initiative, and with the World Bank (FinSAC).

BoA's focus on green finance is also driven by the presence of European banks in Albania, who may be required to comply with the European Banking Authority's ESG related guidelines. The BoA also has invested a small portion of its international reserves in green and/or social bonds, and holds non-monetary portfolios to which responsible investment policies can be easily applied. The BoA's Medium Term Strategy 2022-2024 specifies that the bank will assess the impact of climate change risks on banking and financial activity and consider possible instruments to address them. For that, the BoA is preparing a strategy for climate-related financial risks, which implementation is expected to start in 2023.

A climate roadmap for the Bank of Albania

The challenges that climate change and the transition pose to the Albanian economy and its financial system require urgent planning and action from national authorities. The BoA plays a key role in this context. Its actions can rely on the experience accumulated in the NGFS by several other central banks and supervisors that have already started to adapt their policies to climate change.

Against this background, we suggest a climate roadmap for the BoA, which can be incorporated into the Bank's Medium-Term Strategic Plan 2022-2024. This roadmap aims at integrating climate change considerations into BoA's monetary and financial policies, across its activities.

The BoA should move quickly on this roadmap to keep pace with similar countries, but also because of the commitment by Albania to environmental objectives but, foremost, to seize the opportunities that European investments for the transition offer to Albanian businesses and financial institutions. In addition, the presence of European banks in Albania might increase the need for an alignment of Albanian banks' practices and disclosure regarding climate on international standards.

The roadmap is centred on three building blocks (phases) common to seven parallel work streams, each with a specific policy objective (see Table 1).

Table 1: Climate roadmap for the Bank of Albania

	<i>Stocktaking phase</i>	<i>Preparation phase</i>	<i>Implementation phase</i>
1	Monetary policy Identify channels from climate to economy	Include climate change in inflation policy decision framework Integrate climate channels in economic models	Integrate climate-augmented model in policy decision
2	Financial supervision Survey bank practices	Set supervisory expectations for financial institutions Publish supervisory expectations	Monitor bank alignment with expectations
3	Prudential regulation Map risk and opportunity for banking sector	Implement prudential instruments to address climate change Develop prudential options for identified gaps	Implement prudential instruments
4	Stress tests Develop scenarios	Improve banking sector resilience to climate change Top-down stress test	Bottom-up stress test
5	Data disclosure Identify data gaps	Generate data needed by financial investors and supervisors Develop disclosure principles	Implement disclosure principle
6	BoA policy portfolio Assess risk and impact in balance sheet	Reflect climate challenges in monetary policy operations Develop operational policy options	Implement in monetary policy operations
7	National cooperation Build national working groups	Coordinate national policy response to climate change Explore common policy options	Implement policy package

Communication

International cooperation

Capacity build-up

Phase 1: Stocktaking

As a first step, the BoA must better understand the economic and financial implications of climate change and the transition on the economy and the financial sector. This requires, *inter alia*:

- Analysing the relevant channels from climate change and the transition to Albanian firms and households, as well as to financial institutions.
- Designing transition scenarios that are relevant for Albania for assessing possible transition pathways.
- Engaging with financial institutions to better understand their practices when it comes to climate risk management and the development of sustainable financial solutions.
- Mapping risk and opportunities from climate change for the banking sector as well as assessing their materiality across and within institutions.
- Identifying data resources and gaps in climate economic and financial risks and opportunities.
- Reaching out to other national institutions involved in climate policies.

The objective of this phase is to build up the resources and knowledge necessary to start preparing and implementing the BoA's policy response to address climate risk and support the Albanian economy and financial sector in seizing the related opportunities.

Phase 2: Preparation

In a second step, the BoA must better analyse the available policy options and develop the tools and resources that are necessary for their implementation. This requires, *inter alia*:

- Integrating climate change and the transition in the models and projections that are used for policy decisions.
- Developing prudential regulation and monetary policy options that contribute to addressing climate risk and support businesses and households in the transition.
- Refining assessments of risk and opportunities for the financial sector, as well as setting expectations on their practices regarding climate issues.
- Establishing reliable and comparable data for policymakers and investors, as well as disclosure standards, based on common international definition of sustainable finance.
- Exploring policy options that can be implemented together or in parallel with other national and international authorities.

Phase 3: Implementation

In the final step, the BoA implements the policies developed in the previous phases. These policies are of different types depending on each work stream:

- *Monetary policy*: integration of climate-augmented models and forecasts in the regular monetary policy decision process.
- *Financial supervision*: setting and monitoring supervisory expectations relative to climate risk management practices and adoption of sustainable finance solutions.
- *Prudential regulation*: implementation of financial regulation to address climate change risks and support transition in the financial sector.
- *Stress test*: performing stress tests to improve banking sector understanding of and resilience to climate risks.

- *Data disclosure*: generating data needed by supervisors, investors, and other stakeholders to assess climate risk and opportunities.
- *BoA balance sheet*: implement monetary policy operations that mitigate climate risk for the BoA assets and support the transition.
- *National cooperation*: coordinate the national policy responses to achieve national sustainability objectives.

Note that three themes are cross cutting all work streams and phases:

1. *Communication* is key to guiding financial institutions, businesses, households, and other authorities along the BoA policy process. The BoA narrative and communication strategy may work towards two main goals: Promote Awareness and Foster Dialogue. Informing about the risks that climate change and transition may exert on the economy and the financial system and how it can affect the projections or monetary policy decisions, can be a powerful tool, within the central bank's mandate, toward climate change mitigation and adaptation. Not forgetting the importance of partnership with public, private, civil society, and media actors.
2. *International cooperation* is central to transferring knowledge and experience from other central banks and supervisors in addressing climate challenges in their jurisdiction. Active participation of the BoA in NGFS work is certainly one of the best options for that. International cooperation is also important to implement best practices and international recommendations for incorporating and promoting more effective climate disclosure, as well as to follow the development in international regulation and standards for financial regulators and supervisors.
3. *Capacity build-up* is important, in the first phase, for the BoA to strengthen its modeling and analytical capacity, as well as its assessment of climate risk for financial institutions, and, in the second face to have the knowledge and human resources for implementing policies. The creation of a Sustainable Finance Working Group in the BoA could be a solution for better coordination and cooperation within the bank and with other relevant stakeholders, to smooth the implementation of the action plan and the integration of sustainability aspects into the bank's activities.



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