

State registration with the	Approved by
Ministry of Justice of Azerbaijan Republic	Resolution of November 20, 2009 by the Management Board of the Central Bank of Azerbaijan Republic
Registration No. 3484 December 1, 2009	Protocol No. 33
Minister _____ Togrul Musayev	Governor of the Management Board _____ E.Rustamov

**REGULATIONS ON  
MANAGEMENT OF LIQUIDITY IN BANKS**

**(as amended on April 15, 2010)**

## **1. General provisions**

- 1.1. These Regulations have been developed in accordance with the Laws of Azerbaijan Republic «On the Central Bank of Azerbaijan Republic», and «On banks», other laws of Azerbaijan Republic, regulations issued by the Central Bank of Azerbaijan Republic (hereinafter referred to as the Central Bank), as well as best international practices and standards.
- 1.2. These Regulations identify the minimum requirements with respect to internal liquidity risk and liquidity management policies, procedures and guidelines for commercial banks and local branch offices of foreign banks (hereinafter referred to as banks) operating in Azerbaijan Republic.
- 1.3. All banks shall develop and put in place liquidity risk identification, evaluation and management policies, procedures and guidelines, in consistency with the nature and scope of their operations and activities. Credit, market, operating and other risks affecting liquidity shall also be considered when developing such policies, procedures and guidelines.
- 1.4. The bank's liquidity management policy, procedures and guidelines shall be coordinated by the Management Board with appropriate committee, and shall be approved by the Supervisory Board.
- 1.5. The approved policy, procedures and guidelines of the bank shall be documented and communicated to relevant business units and employees.
- 1.6. Policy, procedures and guidelines shall be subject to a review at least once a year.

## **2. General definitions of liquidity and liquidity risk**

- 2.1. Liquidity is the bank's ability to fulfil its liabilities (hereinafter referred to as liabilities), effectively manage changes that occurred and/or are expected in the sources of funding, as well as finance asset growth as planned without additional expenses.
- 2.2. Liquidity risk is the risk of failure to perform planned and contingency obligations in a timely and effective manner, and a decline of the bank's ability to access additional liquid funds as well as to dispose of its assets promptly with minimum losses.
- 2.3. Maturity distribution for liquidity analysis is a division of assets and liabilities with the same maturities.
- 2.4. Liquidity gap is a maturity mismatch between assets and liabilities. When assets are above or below the liabilities, a positive or negative liquidity gap arises.

## **3. Classification of liquid assets and liabilities**

- 3.1. Liquidity of an asset is defined by the time required to turn it into a highly liquid assets, and the possible losses that may arise.

Assets are classified in the following liquidity categories:

3.1.1 Highly liquid assets — this category includes cash in the national and hard currencies, securities issued by the government of Azerbaijan and the Central Bank, mortgage-backed securities issued by the Azerbaijan Mortgage Fund at the Central Bank, required reserves held with the Central Bank, correspondent accounts with the Central Bank, as well as all domestic and highly rated foreign banks, and «overnight» deposits.

3.1.2. Medium liquid assets — this category includes interbank market short-term financial instruments, deposits held with domestic and foreign banks, other financial institutions, bankable metals, securities issued by domestic banks, governments and central banks of member countries of

the Organization for Economic Cooperation and Development (OECD), as well as investment-grade and repo securities, loans up to 30 days.

3.1.3. Low liquid assets — this category includes assets that cannot be converted into highly liquid assets within a short period of time with minimum losses (other loans, except loans categorized as medium liquid assets, other securities, fixed assets, equity investments, etc., except securities categorized as highly and medium liquid assets).

3.2. Liquidity of a liability is determined by the likelihood of fulfilment of the liability, as well as the liability owner's demand to withdraw his assets from the bank. The higher the probability of withdrawal demands and rights, the higher the liquidity of liabilities.

Liabilities are divided in the following liquidity categories:

3.2.1. Highly liquid (current) liabilities — this category includes all current accounts, including correspondent accounts and «overnight» deposits of banks; demand deposits, liabilities under 30 days (including securities issued by the bank), matured liabilities, contractually unrestrained and irrevocable lines of credit opened.

Borrowings from the Central Bank are not included in highly liquid (current) liabilities.

If a matured liability is not claimed and is considered extended under the contract between the parties, such liability is not included in the highly liquid (current) category.

3.2.2. Medium liquid assets — this category includes liabilities from 30 to 365 days (including securities issued by the bank), debt obligations with maturity over a year but with a contractual entitlement for the creditor to claim early/premature payment.

3.2.3. Low liquid assets — this category includes liabilities with maturity over 365 days.

#### **4. Liquidity risk and liquidity management policy and procedures**

4.1. Given the bank's overall strategy, the liquidity management policy should specify the structure, maturity and management methods of the bank's assets and liabilities, diversity and stability of financing sources, approach to liquidity management in various currencies, range of bank products, asset realization assumptions, etc.

4.2. The liquidity management policy may authorize the bank's branch offices, subsidiary companies and banks to manage their own liquidity, within the scope of limits set by the management.

4.3. Each bank shall develop internal liquidity management procedures, in consideration of the nature and complexity of the bank's operations. Such procedures should provide a comprehensive coverage of the bank's activities giving rise to liquidity risk and the liquidity management process, and should be followed in implementing the bank's liquidity policy.

4.4. The bank's internal liquidity management procedures should identify the business unit or executive officer responsible for controlling the bank's consolidated liquidity position in a centralized manner, the business unit's or the officer's powers and reporting, as well as reporting procedures and interactions with other business units of the bank.

#### **5. Liquidity management process**

5.1. Banks shall form a liquidity management process that would cover at least the following areas of management and control of various areas of their business:

5.1.1. For asset management:

- monitoring of correspondent account balances;
- monitoring of the scope of lending;
- monitoring loan portfolio quality;
- monitoring interest rates on loans;

- monitoring the bank's securities portfolio;
- monitoring repo securities;
- monitoring assets pledged as collateral;
- monitoring marketable fixed and other illiquid assets in order to maintain an adequate level of liquidity.

#### 5.1.2. For liabilities management:

- monitoring the bank's borrowings, in consideration of the recent trends, seasonal factors, interest rate sensitivity and other macroeconomic factors;
- monitoring amount of deposits (including deposits of banks and other legal entities, «overnight» transactions);
- monitoring maturities of deposits and other liabilities;
- regular monitoring and supporting relationships with the creditors of the bank's main liabilities;
- monitoring concentrations of sources of liabilities, considering the type of liability, the creditor and the location;
- monitoring off-balance sheet liabilities.

5.2. *Liquidity gap analysis.* Banks shall carry out liquidity gap analysis at least once a month as follows, given the nature of the bank's operations, structure and composition of assets and liabilities, historic trends in their development path, as well as seasonal and other factors:

5.2.1. Maturities used for internal gap analysis should cover at least instant, 1-7, 8-15, 15-30, 30 days to one year monthly periods, as well as 1-2, 2-3, 3-5 years and over 5 years periods annually. Banks may use shorter periods for the above listed maturity distribution, if necessary.

5.2.2. Maturity distribution of assets and liabilities should be based on the related terms specified in the underlying agreements, conservative approach to asset sales opportunities, assumptions of development path of borrowed funds. Gap analysis should consider only the principal amounts of assets and liabilities (excluding interest).

5.2.3. The bank's cash funds in the national currency and foreign exchange should be assigned in full to the «instant» maturity. Assets such as correspondent accounts held with the Central Bank and other banks, «overnight» deposits held with banks, and liabilities such as correspondent accounts of other banks held with the bank, demand deposits of legal entities and individual, «overnight» deposits of banks may be assigned in full to «instant» maturity or distributed among several maturities calculated in accordance with the criteria defined by the bank for each type of assets/liabilities. Such criteria shall be based on the statistics of past periods and analysis of historic trends.

5.2.4. When conducting a gap analysis, banks may assign term liabilities to appropriate maturities or to the real liquid extent of their value. The real liquid amount of the bank's liquidity in an appropriate maturity is the part thereof in that period that is highly likely to be executed, in the bank's judgment. To identify the real liquid amount of liabilities banks should use appropriate criteria for each type of liabilities, statistics of past periods and analysis of historic trends. In order to ensure that the criteria are adequate, the bank's management should regularly review them.

5.2.5. Past due loans, fixed assets, intangible assets, equity investments, other term less assets and capital elements shall be assigned to the last (the longest term) maturity in gap analysis.

5.2.6. to control the foreign exchange-denominated liquidity position, banks shall conduct separate gap analysis for foreign exchange, specify the Manat equivalent in the maturity distribution schedule, as well as evaluate the overall foreign exchange demand.

Considering the outcomes of the gap analysis of foreign exchange, banks shall regularly monitor their ability to access borrowings on foreign markets, availability of appropriate currency sources on the domestic market, prompt convertibility of one currency to another, exchange rate fluctuations and possible adverse effects on the underlying assets.

5.2.7. Gap analysis should include an analysis of individual and cumulative negative liquidity gaps and comparison against the limits set by banks in accordance herewith.

5.2.8. Findings of gap analysis should be properly documented and reported to the management.

The bank's executive officer/business unit shall prepare the decisions regarding implementation of appropriate measures in consistency with the results of the gap analysis and submit them to the bank's Management Board for approval.

5.3. *Instant liquidity ratio requirement.* Each bank shall maintain the ratio of average daily highly liquid assets to average daily highly liquid (current) liabilities at least at the rate of 30 percent.

Liabilities with maturity of 8 to 30 days (including securities issued by the bank) classified as highly liquid (current) liabilities shall not be included in the calculation of the bank's instant liquidity ratio.

If a bank has past due liabilities to creditors and depositors (including all debts to the Central Bank and other banks), the bank is deemed to have breached the instant liquidity ratio, irrespective of whether the bank is in compliance with the instant liquidity ratio.

5.4. *Limit setting.* The bank's internal procedures shall identify at least the following limits in order to provide a liquidity level adequate in relation to the bank's size (assets, capital, customer base, operations), nature and financial position:

- limit for the ratio of the cumulative negative liquidity gap of at least 0-7, 0-30, 0-90, 0-180, 0-365 maturity brackets to total assets;
- maximum amount of the bank's liabilities per creditor or a group of connected creditors (individuals and legal entities, banks, international and other financial institutions), or the maximum ratio to total liabilities;
- maximum ratio of annual principal payments on all liabilities with maturity over one year to total liabilities.

The bank's internal procedures shall identify limit compliance procedures, including procedures for removal of incompliance, as well as the frequency of comparing actual liquidity indicators against the limits established. The limits defined in the bank's internal procedures shall be regularly reviewed in order to ensure that the bank's current and projected liquidity position is adequate.

Any instances and causes of limit violation shall be documented and reported to the management. The bank's procedures should include measures to be taken to modify the bank's liquidity management procedures depending on the extent of violation of limits.

5.5. *Analysis of liquidity ratios.* Banks shall define procedures for evaluating and comprehensively analyzing the liquidity position and demand for liquid funds, as well as for presenting analysis and evaluation findings to the management. Banks may use the following liquidity ratios in addition to the requirements and limits identified in paragraphs 5.3 and 5.4 hereof for liquidity analysis:

- *Ratio 1: Ratio of highly liquid assets to total assets.*
- *Ratio 2: Ratio of current assets to highly liquid (current) liabilities (current liquidity ratio).* Current assets include, in addition to highly liquid assets, any assets with maturity up to and more than 30 days.

A decline in ratio 1 and 2 indicate a reduction in high quality assets, or the bank's excessive reliance on the volatile sources of funding normally used for short-term. Such a reduction does not only indicate a deterioration of liquidity condition, but may also indicate acceptable changes in the financing strategy.

- *Ratio 3: Ratio of highly liquid (current) liabilities to total assets.* This ratio measures the level of financing of assets from short-term liabilities. If this ratio is high, it indicates the bank's high dependence on unstable sources of funding.
- *Ratio 4: Ratio of highly liquid (current) liabilities to total liabilities.* This ratio evaluates the

scope of funds that might leave the bank at early signs of problems. If a bank has large highly liquid liabilities, it should have a more stringent emergency/contingency liquidity plan.

- *Ratio 5: Ratio of loans to deposits.* Loans in this ratio include net loans to customers other than interbank loans (less the possible loan loss reserves), and deposits are deposits of customers held with the bank, other than deposits of other banks. This ratio measures the extent to which the bank finances the loan portfolio. An increased ratio indicates the bank's greater reliance on unstable sources of funding (e.g., short-term borrowings).
- *Ratio 6: Ratio of securities pledged as collateral to total securities.* This ratio indicates the percentage of securities pledged as collateral which cannot be used to cover liquidity needs.
- *Ratio 7: Ratio of total funds attracted on domestic financial markets to total funds attracted on foreign markets.* This ratio is designed for regulating the concentration of funds attracted by the bank from domestic and foreign markets.
- *Ratio 8: Ratio of total demand deposits and stable balances of correspondent accounts of banks to total liabilities.* This ratio identifies what portion of the total liabilities are demand deposits and stable balances of correspondent accounts. A stable balance means an amount that has remained in and has not been withdrawn from the account for one year.

5.6. *Early warning system.* Banks shall have an early warning system and procedures that analyze the possible critical situations, identify increased risks of adverse changes in the liquidity position and increased need for additional funding.

The early warning system should consist of regularly monitored quantitative and qualitative criteria. The early warning system should cover at least the following criteria:

- an excessive growth of low liquid and/or illiquid assets, especially assets funded from highly liquid liabilities;
- increasing concentration of assets and liabilities by types;
- increase of liquidity gaps;
- reduction of average weighted maturities of liabilities;
- regular proximity of limits established, failure to comply with internal and prudential limits;
- a dramatic decline of the bank's profitability indicators, deterioration of asset quality and overall financial position;
- price decline of the bank's equities, bonds and other securities;
- increasing funding costs;
- bank's creditors requiring additional security;
- closure of lines of credit opened for the bank;
- deposit run-off, including unmatured deposits;
- difficulties in accessing long-term funding;
- difficulties in placing short-term liabilities;
- public information that may have an adverse impact on the bank;
- decline of ratings assigned by rating agencies;
- deterioration of the bank's reputation.

5.7. *Stress-test and scenario analysis.* In order to project the bank's liquidity position effectively, the bank should stress-test its liquidity position at least once a month.

The stress-test scenario should be developed taking account of various criteria such as assumptions associated with the bank and the nature of its operations (types of bank transactions and products, sources of funding), current and project market conditions, as well as the effects of ratings assigned by international rating agencies.

When conducting a stress-test, it should be remembered that the contractual amounts of term assets and liabilities used do not necessarily reflect their real liquid value.

Stress-test assumptions may include:

- Stress-test for assets:
  - timely repayment or delinquency of loans (liquidity risk rising in connection with credit risk);
  - the Central Bank revises the reserve requirements;
  - reduction of the bank's liquid assets;
  - market value of liquid assets changes.
- Stress-test for liabilities:
  - holders of term liabilities requiring their funds back early;
  - reduction of funds in current and correspondent accounts;
  - currency of customer deposits changes;
  - large deposit run-off;
  - early revocation of funds from banks and other financial institutions;
  - line of credit agreement breached (early termination, contractual amounts not disbursed in full or in time).
- Assumptions affecting assets and liabilities:
  - interest rates change;
  - inflation rate fluctuates;
  - exchange rate fluctuates drastically.

Liquidity stress-tests may be carried out at foreign branch offices, subsidiary companies and subsidiary banks of the bank may be carried out separately in accordance with the bank's pre-determined procedures. In this case, results of the stress-test shall be reported to the bank's head office.

Banks should develop «the worst case», «the best case» and «probable» scenarios of development of liquidity position changes and, considering the above described assumptions, separate criteria should be developed for each scenario.

Each scenario should include all balance sheet and off-balance sheet items. Any changes in these items should be analyzed and should be considered in the bank's liquidity and financial performance projections.

Assumptions used in stress-tests shall be subject to approval by the bank's appropriate committee. Results of stress-tests and scenario analysis shall be presented to the bank's management and other relevant employees of the bank.

The bank's appropriate committee shall prepare and the Supervisory Board shall approve the decisions for making necessary amendments to the bank's strategic plan, as well as limits and liquidity management based on the results of stress-tests and scenario analysis.

*5.8. Emergency/contingency liquidity plans.* Banks should have a plan (hereinafter referred to as the contingency plan) that identifies the procedures for accessing liquid funds and turning assets into liquid funds with minimum losses in cases of emergency in order to ensure continuous and undisrupted operation of the bank.

This plan shall be developed in consistency with the bank's structure, nature of operations, risk profile, scope of operations, region of business. The contingency plan should, considering the bank's needs for liquid funds, as well as important payments for the bank and their priority in execution, clearly identify potential sources of funding in cases of unexpected shortage of liquid

funds, funds that the bank would be realistically able to acquire, required timeframes and associated costs.

The contingency plan should be developed in conjunction with a number of the bank's related business units (Risk Management Committee, Treasury, Asset and Liabilities Management Committee, Information Technologies, Payment Systems and Financial Service) and approved by the Supervisory Board. The plan should identify emergency response procedures and a clear division of related duties and powers.

The contingency plan should be reviewed and approved at least once a quarter, in consistency with the current situation. Assumptions used in the plan should be stress-tested in order to ascertain that the plan is up to date.

The contingency liquidity management plan should identify:

- amount and composition of funds considered the most stable among attracted funds;
- from the standpoint of likelihood of reduction of sources of funding attracted by the bank in connection with an unexpected liquidity deficit, classification of such sources of funding;
- term and term less liabilities expected to reduce immediately as soon as early signs of unexpected liquidity deficit arise;
- the bank's sources and ability to raise additional funding, including additional capital (in consideration of prudential requirements and internal limits and other standards);
- expected maximum period of time required to restore undisrupted operation of the bank if an unexpected liquidity deficit arises.

The plan should identify assets that may be used as security or disposed of immediately.

5.9. *Diversification of sources of funding.* Banks should diversify their funding sources depending on the nature of their operations, type of products and markets they operate in. Funding sources should be diversified as follows:

- by various types of deposits;
- by use of other various types of attracted funds (e.g., commercial securities issued by the bank) as security of the bank's liabilities, other than deposits;
- by various types of depositors/creditors (individuals and legal entities, Central Bank, other government agencies, banks and other financial institutions, etc.);
- by geographic location, country, region.

In order to ensure that components of diversification are adequate in relation to the existing conditions, they should be reviewed at least once a quarter.

5.10. *Collateral management.* If additional funding is required for balance sheet and off-balance sheet operations, assets usable as collateral should be regularly monitored. Banks should ensure that no legal, regulatory or internal limitations exist as far as immediate use of such assets with as little loss as possible is concerned.

5.11. *Liquidity of branch offices.* The bank's internal procedures should identify the requirements to liquidity of branch offices, liquidity management procedures and liquidity position reporting system, in consideration of the scope and nature of operations of branch offices.

The branch office liquidity management system should cover liquidity requirement planning given the bank-established maturities, as well as procedures for interaction with the bank's head office and other branch offices in order to provide and/or increase the branch office's liquid funds.

## 6. Reporting system and submission of reports

6.1. *Internal reporting system.* The bank's management shall receive regular and, in emergencies, immediate liquidity status reports.

The bank's reporting system should cover the liquidity management processes noted in paragraph 5 hereof. In addition, the reporting system shall also contain the following information in order to inform the bank management as well as other authorized employees:

- liability concentration data: largest providers of funds/liability holders, their lines of business and geographic distribution, type of resources (current account, term deposit, interbank loan), amount of funds, interest rate and other details;
- list of the most marketable assets;
- list of assets currently pledged as collateral and, if additional funding is required, may be pledged as collateral or refinanced in the future;
- recovery of loans and other liabilities, future fixed asset acquisition and long-term investment financing plan (internal) and projections (considering external impacts);
- value of various resources for return on assets and performance of bank transactions (current and projected values for funding sources);
- regular reports for evaluation of the current market conditions, as well as the bank's ability to access market and sell assets as quickly as possible to ensure diversification of liabilities.

6.2. *Management Information System (MIS).* Banks shall develop and put in place an adequate information system in order to:

- measure, monitor and control liquidity risk on a daily basis;
- identify and modify maturities for analysis of liabilities;
- check compliance with procedures and limits established;
- monitor trends of liquidity indicators;
- develop various reports in the format defined in regulatory requirements and internal policies.

The MIS should be able to monitor the development path of the criteria identified in the early warning system and alert the bank management if any indicator reaches a critical level.

The MIS should allow for calculating the liquidity position for each currency, as well as the total liquidity position for all currencies used by the bank.

The MIS-generated reports shall be regularly presented to the bank's Supervisory Board, Management Board and relevant employees.

6.3. *Internal control of liquidity risk management.* The bank's internal controls should ensure that the liquidity management processes are adequately controlled. The main component of internal control is the regular independent evaluation of the liquidity management system and presentation of requirements to make necessary changes in this system. Findings of such evaluations shall be properly documented and reported to the bank management.

6.4. *Reporting to the Central Bank.* Banks shall prepare their liquidity position reports, including maturity distribution and instant liquidity reports in accordance with the format and procedure requirements of the prudential reporting system and presented to the Central Bank as part of prudential reports.

6.5.*Disclosures to users.* Banks shall disclose their liquidity risk details to users in accordance with the Central Bank's related regulations. In addition, the bank's own policy may provide for additional disclosures on the bank's stability.