

Regulation on credit risk management in non-bank credit institutions

1. General provisions

This Regulation has been developed in accordance with Article 19.1.1 of the Law of the Republic of Azerbaijan ‘on Non-bank credit institutions’ (hereinafter – the Law) and Article 744.3 of the Civil Code of the Republic of Azerbaijan and determines the requirements regarding credit risk management in non-bank credit institutions (hereinafter – NBCI), as well as the procedure for calculating the actual annual interest rate on loan agreements.

2. Definitions

2.1. The definitions used in this Regulation bear the following meanings:

2.1.1. credit risk – the risk of loss resulting from borrower’s, or issuer's failure to perform obligations under contractual terms.

2.1.2. risk appetite – the volume of risk the NBCI is willing to accept within its risk-taking capacity to achieve the goals outlined in its commercial strategy.

2.1.3. effective annual rate – annual rate on a loan calculated as per Annex 2 herein.

2.1.4. consumer loan – a loan to individuals issued for purposes not related to entrepreneurial or professional activities, and the acquisition or construction of real estate.

2.1.5. daily (short-term) loan (hereinafter – daily loan) – a consumer loan that stipulates the payment of interest and/or other charges specified in the agreement either on the day the principal amount is disbursed, simultaneously with the repayment of the principal (except in cases where the principal is repaid in installments) or calculated in days (not exceeding 30 days). Daily loans should meet the following requirements:

2.1.5.1. they are issued in the national currency.

2.1.5.2. the maximum amount of a one-time loan to the borrower is AZN500 (five hundred).

2.1.5.3. the daily interest rate is maximum 0.3%.

2.1.5.4. maturity is maximum 45 (forty-five) days.

2.1.5.5. in the cases involving delinquent payments, delinquent fees, or penalties (except in cases where delinquent payment interest is applied) should not exceed twice the daily interest rate applied to the remaining principal amount.

2.1.5.6. the total amount of all payments to be made on the loan should not exceed 100% of the principal amount.

2.1.5.7. where delinquency interest or penalties are applied, interest on the principal amount should not be calculated for more than 30 (thirty) days.

2.1.5.8. real estate or movable property is not used as collateral.

2.1.5.9. not restructured.

2.1.6. business loan – loans issued to legal entities and unincorporated individuals for entrepreneurship, as well as agricultural loans.

2.1.7. agriculture loan – a business loan issued in national currency to micro, small, and medium-sized enterprises (MSMEs) and family farms operating in the agricultural sector (hereinafter – agricultural entities) for financing at least three-quarters of the cost of agricultural production (such as the purchase of agricultural production tools, mineral fertilizers, bio humus, seeds, and pesticides, as well as the use of agrochemical and agronomic services, etc.), trading and processing of agricultural products manufactured by the agricultural entity, as well as the development projects in the agricultural sector, including the establishment of orchards, construction of storage facilities for agricultural products, and establishment of livestock (e.g., fishery, poultry farming, etc.) enterprises.

2.1.8. real estate loan – a loan issued to individuals for the purpose of acquiring or constructing real estate for personal consumption.

2.1.9. agricultural production tools – agricultural machinery (such as tractors, soil preparation and cultivation equipment, seeding and planting machinery, harvesting and collection equipment, fertilizer spreaders and preparation machines, etc.), technological equipment, including irrigation system kits and equipment, as well as breeding livestock.

2.1.10. monthly installment – the payment of the principal amount and accrued interest, and/or other payments specified in the agreement, made in equal installments each month (annuity payments). In credit line agreements and contracts where annuity payments are not provided (such as loan, lease, and other debt liabilities), the monthly payment is calculated using the annuity method based on the total amount of the liability (credit limit for credit lines) and the remaining duration of the agreement.

2.1.11. borrower's income – the borrower's average monthly income for the last 6 (six) consecutive months, confirmed by relevant documents (such as a salary certificate from the workplace, a tuition certificate from the educational institution, a certificate from the authority responsible for social protection confirming the payment of pensions and allowances to the borrower, a bank statement confirming interest income from the borrower's existing deposit accounts, or other documents confirming income), or for borrowers whose income is not related to salaried work (i.e., work performed under an employment agreement in accordance with labor legislation), the average monthly income for the last 12 (twelve) months and other sources of income. The borrower's average monthly income is calculated by dividing the total income for the previous 6 (or 12 for borrowers not engaged in salaried work) months by 6 (or 12). If integration with the relevant state authorities' (institutions') electronic information systems is provided, the relevant documents and data can be obtained by the NBCI in real-time from that information system.

2.1.12. other income – the income determined based on the actions to be taken in accordance with the internal methodology approved by the Supervisory Board (or Trustee Board) of the NBCI, which may include reviewing the borrower's area of activity, determining the existence and amount of specific income, obtaining supporting documents and information, or using other methods.

2.1.13. restructuring – the modification of contractual terms or the formalization of a new debt obligation aimed at ensuring the fulfillment of borrower's debt obligations due to borrower's financial difficulties or directing the fulfillment of existing debt obligations with the same NBCI. The borrower's financial difficulty refers to situations where borrower's cash flows are inadequate to meet obligations under existing contractual terms, as well as cases

where total amount of borrower's obligations is overdue by more than 90 (ninety) days, representing at least 20 (twenty) percent of the total debt, according to credit bureau information, or the likelihood of such events occurring. The modification of contractual terms refers to any of the following:

2.1.13.1. interest rate cuts.

2.1.13.2. the reduction of the principal amount, accrued interest, and/or other payments specified in the agreement.

2.1.13.3. prolongation of the asset maturity.

2.1.13.4. the granting of a new or additional grace period (during which no payments are made, or only interest and/or other payments specified in the agreement are made).

2.1.13.5. rescheduling of the principal amount, interest, and/or other payments specified in the agreement.

2.1.13.6. the provision of more favorable rights and benefits to the customer by the NBCI than those stipulated in existing contractual terms, except for the provisions outlined in sub-items 2.1.13.1 to 2.1.13.5 of this Regulation.

3. Credit risk management system

3.1. The credit risk management system of NBCIs includes the following elements:

3.1.1. credit risk management policy.

3.1.2. credit risk assessment.

3.1.3. credit risk monitoring.

4. The credit risk management policy

4.1. The NBCI's Supervisory Board (Board of Trustees) should approve the credit risk management policy in line with the NBCI's risk appetite.

4.2. The credit risk management policy covers at least:

4.2.1. the maximum amount of loans issued to a borrower and a group of joint borrowers for each type of loan, as well as to related parties of the NBCI, and the procedures for assessing the borrower's repayment capacity.

4.2.2. procedures for appraising collateral, including the criteria for selecting an external appraiser.

4.2.3. procedures for maintaining credit administration.

4.2.4. rules for the management of non-standard loans.

4.2.5. reporting.

4.3. requirements for the internal risk rating system and the criteria included in it, in accordance with the volume of the NBCI's operations, as part of the credit risk management policy, which may include the conduct of stress tests.

4.4. The non-standard loan management procedures address the impact of internal and external factors on the management of non-standard loans by the NBCI, the goals for capacity building of the NBCI (such as the availability of resources, information technologies, etc.) in managing non-standard loans, and the targets for reducing the volume of non-standard loans in the short, medium, and long-term periods.

4.5. An actions plan is developed in accordance with the non-standard loan management procedures. The plan is approved by the executive body of the NBCI and

reviewed at least once a year. The plan includes measures for reducing non-standard loans, timelines for their implementation, and the resources required for these measures.

4.6. The internal rules specified in Item 4.2 of this Regulation should ensure the avoidance of the conflicts of interest.

4.7. The credit risk management policy should be communicated by the executive body of the NBCI to its staff.

5. Credit risk assessment and administration

5.1. NBCIs assess borrowers' creditworthiness during emergence of credit exposures, as well as introduction of new NBCI products and considers at least the following:

5.1.1. consumer loans (except for daily loans):

5.1.1.1. borrower's income

5.1.1.2. borrower's age and work experience.

5.1.1.3. the purpose of the loan and its repayment source.

5.1.1.4. borrower's credit history.

5.1.1.5. the LTV ratio (in case of a collateralized loan).

5.1.1.6. alternate ways for debt repayment if borrower's main income decreases.

5.1.1.7. the level of borrower's expenses, as well as probabilities for increase or decrease in borrower's expenses over loan maturity.

5.1.2. the following is considered along with the criteria specified in sub-items 5.1.1.3 – 5.1.1.5 herein related to other credit exposures (business loans to large and medium-sized businesses, guarantees, etc.):

5.1.2.1. the ways to repay debt in case of deterioration of borrower's cash flows under different scenarios.

5.1.2.2. if a legal entity, information on borrower's shareholders and members of its management body.

5.1.2.3. borrower's business experience and position in the sector.

5.1.2.4. borrower's financial standing (where the borrower is a holding company or a company in the holding company, on a consolidated basis). At that, borrower's, or issuer's financial statements (if any, financial statements reviewed by an external auditor together with an auditor opinion), reports submitted to tax authorities, as well as borrower's or issuer's business plan (if a new type or area of business is created) are reviewed. Borrower's financial statements cover at least the last 1 (one) year period from the date of submission of the loan application (if the borrower has been in business for less than 1 (one) year, the period during which the borrower has been operating).

5.1.3. At least one year turnover and financial statements are considered in business loans to small entrepreneurs along with the criteria set in sub-items 5.1.1.3-5.1.1.5 herein (if the borrower has been in business for less than 1 (one) year, the period during which the borrower has been operating).

5.1.4. if the loan is issued for use in a foreign country, in addition to the requirements of sub-items 5.1.1–5.1.3 of this Regulation, factors such as the impact of economic and political conditions in the country where the loan is utilized on its repayment capacity, as well as potential risks that may arise in the fulfillment of obligations under the loan agreement and the sale of collateral should also be considered.

5.1.5. In relation to loans to micro-entrepreneurs, in addition to the requirements of sub-items 5.1.1.3–5.1.1.5 of this Regulation, results of the review conducted on borrower's

activities should be assessed. If the borrower has no ongoing activities, the business plan, which includes forecasts of expenses and cash flows, is evaluated.

5.1.6. When assessing the creditworthiness of borrowers for agricultural loans, in addition to the requirements of sub-items 5.1.2, 5.1.3, and 5.1.5 herein, the existence of insurance coverage, which encompasses at least the loan amount, as well as includes a condition in the insurance agreement stipulating that, in the event of an insured incident, the insurance payment for the outstanding loan amount is made to the NBCI as the beneficiary (e.g., agricultural insurance), is taken into account. If the loan is financed by more than one credit institution, the insurance agreement should specify the terms for allocating insurance funds among credit institutions in the event of an insured event.

5.2. At the time of credit exposure, it is verified whether the borrower relates to a group of related borrowers, as well as to NBCI's related parties.

5.3. Borrower's creditability is assessed in all cases, whether the loan exposure is secured or unsecured in consideration of Item 5.1 herein.

5.4. Automated assessment of borrower's creditability via information systems is maintained in consideration of the requirements herein.

5.5. Results of the borrower's credit risk analysis per loan application and the decision regarding the issuance of the loan are documented and kept in the credit file. The list of documents and information to be included in the credit file is specified in Annex 1 herein.

5.6. A registry of loan applications is maintained, and if a loan application is denied, the NBCI should provide a clear written response to the applicant upon his/her request, specifying the reasons for the denial.

5.7. When a loan is issued, a loan agreement is concluded between the borrower and the NBCI. The relations under the loan agreement, including consumer loan agreements, are governed by the Civil Code of the Republic of Azerbaijan. The standard information form provided to the borrower for consumer loans is prepared in accordance with the 'Standard information form for consumer loan agreements,' approved by Decision No. 38/2 of the Management Board of the Central Bank of the Republic of Azerbaijan dated 26 July 2023.

5.8. When a consumer loan agreement is concluded remotely, requirements of the Civil Code of the Republic of Azerbaijan and Section 5 of the 'Regulation on opening, maintaining and closing bank accounts,' approved by Decision No. 04/2 of the Management Board of the Central Bank of the Republic of Azerbaijan dated 4 February 2022 should be adhered to.

5.9. The effective annual rate (EAR) on a loan is calculated as per Annex 2 herein. In accordance with the Law of the Republic of Azerbaijan 'on Advertising,' if any cost related to a consumer loan is specified in an advertisement, the loan's EAR should also be disclosed.

5.10. The structural unit responsible for assessing credit risks in the NBCI should be separate from the structural unit responsible for issuing loans.

6. Monitoring of credit risks

6.1. The NBCI should have procedures and information systems in place to monitor credit risks. Credit risk monitoring procedures include monthly monitoring of loans based on the number of delinquent days for classification purposes by the NBCI, inspection of the condition and maintenance of movable or immovable property acting as collateral, verification of the use of loan for its intended purpose, and loan restructuring procedures and requirements.

6.2. The structural unit that performs credit risk monitoring function should be separate from the structural unit that performs the function of issuing loans.

7. Requirements for granting loans

7.1. Real estate loans are issued in the national currency only.

7.2. If a consumer loan fails to meet the daily loan requirements, borrower's solvency is evaluated in accordance with the provisions of Section 5 herein. The NBCI may not issue a new daily loan to a person with an outstanding daily loan, and a new daily loan may only be issued to that person 3 (three) business days after the full repayment of the existing loan.

7.3. Foreign currency denominated loans may be issued only to persons with foreign currency income.

8. Final provisions

8.1. This Regulation applies to NBCIs active until the effective date of this Regulation, 1 (one) month after the day it takes effect (taking into account Items 8.2 to 8.4).

8.2. The requirements of sub-item 2.1.5.9 (regarding loans issued before the date this Regulation takes effect), Section 4, and Items 5.2 to 5.6 and 7.2 of this Regulation apply to NBCIs active until the date this Regulation takes effect, 3 (three) months after the date it takes effect.

8.3. The requirements of Items 5.1 and 5.8 and Section 6 of this Regulation apply to NBCIs active until this Regulation takes effect, 6 (six) months after the date it takes effect.

8.4. The requirements of Items 7.1 and 7.3 of this Regulation apply to loans issued by NBCIs active until the date this Regulation takes effect after the Regulation takes effect, as well as to loans issued before this Regulation takes effect but restructured after the Regulation takes effect.

Credit file

1. General documents

1. Loan application (order) indicating loan amount, currency and term required under the loan agreement signed by the borrower him/herself or his/her authorized person.

2. Regarding the borrower, or his/her authorized representative, along with the information and documents obtained in accordance with the 'Regulations on customer compliance and verification measures during application of new technologies, identification of risk factors and assigning customer profiles to risk groups' adopted in accordance with the Law of the Republic of Azerbaijan 'on Prevention of the legalization of the criminally obtained property and the financing of terrorism' (hereinafter – the AML/CTF Law):

2.1. if the borrower is a legal entity or a private entrepreneur, the actual address.

2.2. borrower's activity area (individual's employment area or social status).

3. If the borrower is a legal entity, a relevant decision of its competent management body on obtaining a loan and a document confirming the authority of the person empowered to sign loan documents.

4. the source of cash flows for loan repayment (indicating main and reserve sources).

5. information whether the loan is secured or non-secured.

6. a report on assessment of borrower's creditability developed by the NBCI.

7. a business plan (if required depending on the type of the loan).

8. opinion of relevant departments or authorized persons of the NBCI on granting a loan in accordance with internal procedures.

9. extract from the minutes of the meeting of authorized units of the NBCI on issuance of loans or a decision to issue a loan signed by relevant authorized persons.

10. loan agreement.

11. Information constituting credit history on borrower's liabilities in the cases provided for in this Regulation.

12. If the borrower is a legal entity, its annual financial statements approved with auditor opinion (if any) (obtained at the time of issue of the loan) for the fiscal year ended. If the borrower is the NBCI's related party, its annual financial statements for at least recent 2 years approved by the auditor's opinion (if any).

13. If the borrower is a legal entity, annual financial statements over the loan maturity.

14. If the borrower is a legal entity, NBCI's opinion on its corporate governance structure.

15. Information on concentration risk related to one borrower or related groups of borrowers (if any).

16. If the borrower is a legal entity/individual, internal risk rating issued by the NBCI.

17. Documents confirming the intended use of the loan (copies of borrower's agreements with sellers and contractors, documents confirming expenses, etc.).

18. Report on the use of the loan for its intended purpose during the loan maturity and on findings of review and monitoring of the borrower's financial condition, prepared by the relevant structural unit of the NBCI.

19. Agreements and other documents regarding the loan restructuring.

20. A standard notification form on the consumer loan delivered to the consumer.

21. If the loan is granted through a related credit agreement in connection with the purchase of a specific goods or supply of services, a document confirming the purchase of those goods or services.

2. Documents related to securitization

1. A collateral agreement concluded (approved) in accordance with the legislation.

2. Copies of documents confirming the right of ownership about collateral.

3. Documents confirming consent of all owners in connection with formalization of collateral if it is jointly owned (if the consent is provided for by law), as well as documents confirming the consent of the previous pledger (mortgagor) during the subsequent pledge, unless the subsequent pledge is prohibited by the previous pledge agreement.

4. Documents confirming the purchase price of the asset if the NBCI finances purchase of the collateral (real estate, car, etc.).

5. Report on results of appraisal indicating the date, method, and appraiser of pledged collateral.

6. Report on inspection of collateral's physical and technical condition: information on the type of collateral inspected, the place of inspection, first, last names and positions of the person conducting it, as well as results of the appraisal (indicating its condition, etc.).

7. Documents related to insurance (insurance agreement and certificate) if the NBCI requires insurance of collateral in its favor.

8. If collateral is in the form of a guarantee or a warranty, information on the financial condition of the guarantor or the warrantor and results of its assessment by the NBCI.

9. Documentation of the replacement of collateral (if necessary).

10. If the guarantor is a legal entity:

10.1. foundation and state registration documents.

10.2. decision of guarantor's competent management body (if the powers belong to the collegial management body).

10.3. documents confirming authorities of the person empowered to sign a collateral agreement.

11. If the guarantor is an individual:

11.1. information confirming source(s) of his/her income.

11.2. information on his/her creditability, including credit history information.

12. Documents confirming blocking of account for loans secured with pledged money.

3. Other documents

1. Documents on debt collection (letters to borrowers, results of debt collection measures, etc.).

2. Documents on construction projects for construction loans (if any).

3. Other legal documents (e.g., any formal claim against the borrower or a formal complaint / claim filed by the borrower against the NBCI).

4. Correspondence with the borrower.

5. Other documents provided for in internal procedures of the NBCI.

6. The following documents additionally on agriculture loans:

6.1. permits, certificates and other legal documents of the borrower in the field of agriculture (if required by the legislation).

6.2. sales plans, agreements, or protocols of intent for the sale of the product to be produced (if any).

Methodology for calculation of an effective annual rate (EAR)

A. The EAR is calculated using the mathematical equation shown below:

$$S = \sum_{k=1}^n A_k \left(1 + \left[\frac{x}{m}\right]\right)^{-k}$$

S – net loan amount given to a borrower, i.e., difference between allocated loan and current payables to the NBCI.

k – serial number of cash flow (payment and other expenses).

n – the number of cash flows (payments and other expenses).

x – effective actual rate.

m – annual payment interval.

A_k – k total cash flows (payments and other expenses) on loan agreement. Two-way cash flows are entered in the calculation with opposite mathematical signs, i.e., cash outflows with 'negative' and cash inflows with 'positive' signs.

B. The following spending items are not included to EAR calculation:

a) expenses related to the requirements of the legislation (e.g., compulsory insurance, notary fees, etc.), not to the terms of the loan agreement.

b) insurance costs that do not restrict access to the loan.

c) insurance premiums not known to the NBCI in advance.

d) expenses likely to arise from borrower's non-compliance with the terms of the loan agreement (e.g., penalties for delay, delinquency charges, etc.).

e) payments envisaged in the loan servicing agreement, the amount and/or duration of which depends on the decision and/or behavior of the borrower, including:

i. compensation expenses for premature repayment of the loan in full or in part.

ii. expenses for exceeding overdraft limit set for the borrower.

iii. payments for obtaining information on the status of the loan debt.

iv. credit card conversions and other similar deductions.

C. EAR on loans issued via credit cards (lines) is calculated considering the following:

a) if the loan agreement allows the borrower to act freely on use of the loan, the option of the use of the loan in full on the date of the issue of the loan is considered. If the loan is to be used in installments, the amount of the part that can be freely used is considered.

b) if the loan agreement defines a free behavior on loan use and different interest rates and/or other payments are specified to be required on this basis, the calculation considers the highest possible requirements.

c) If the loan agreement does not envisage a repayment schedule, the following is assumed:

i. loan maturity is one year.

ii. making repayments monthly and in equal installments.

d) if the loan agreement repayment schedule specified only the term, and amount of repayments is free (i.e. not set by the agreement), it is assumed that the smallest payment (only interest and (or) other payments specified in the agreement) will be made and the principal amount will be paid at the end of the term.