THE CENTRAL BANK OF
THE REPUBLIC OF AZERBAIJAN

№4(12)
2012

FINANCIAL STABILITY REVIEW

Q4

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Acronyms

CBA	–	The Central Bank of Azerbaijan
AMF	–	The Azerbaijan Mortgage Fund under the Central Bank of the Republic of Azerbaijan
AZIPS	–	The Real Time Gross Settlement System
IMF	–	The International Monetary Fund
SSC	–	The State Statistics Committee of the Republic of Azerbaijan
HHI	–	Herfindahl-Hirschman Index
BCSS	–	The Retail Payment System
DGCs	–	Developing Countries
DDCs	–	Developed Countries
MF	–	The Ministry of Finance of the Republic of Azerbaijan
REER	–	Real Effective Exchange Rate
ROA	–	Return on Assets
ROE	–	Return on Equity
GDP	–	Gross Domestic Product

INTRODUCTION

The Central Bank of the Republic of Azerbaijan pursued its financial stability policy in 2012 in the environment of fragile growth in the world economy, elevated global risks and volatility in the global financial and commodity markets. Growth dynamics of the country economy continued over the year stemming mainly from the non-oil sector and macroeconomic stability was maintained amid global uncertainties.

The CBA targeted maintenance of inflation at a satisfactory level, stability of the exchange rate of manat, strengthening of growth and sustainability in the banking sector amid safeguarding macroeconomic stability and diversification of the economy.

In order to maintain financial sustainability of the banking system the Central Bank has taken measures on reinforcing risk managament potential in banks, improving the supervisory-regulatory system and raising the capitalization level of banks. At the same time, deepening of financial intermediation of the banking system was on the spotlight.

The measures taken deepened growth processes in the Azerbaijani banking system and maintened the financial stability in 2012. Capital and liquidity stance of the banking sector remained on an acceptable level expanding its resource base through sustainable sources. The banking system played a more active role in supporting growth of the non-oil economy and widened its regional scope.

I. OVERVIEW OF THE BANKING SECTOR PERFORMANCE

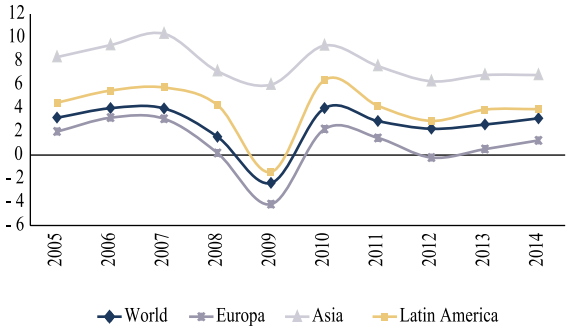
1.1. Recent trends on the global financial stability

Financial stability risks remained in the global economy over the last year, the main reason of which was unstability in Europe, particularly in the recessed Eurozone amid the necessity to carry out budget consolidation programs.

While the global economic growth continued in 2012, its rate declined compared to the past year. The growth was chiefly achieved at the expense of DGCS and the USA. Following the long-term depression, the Eurozone economy did not grow and Japan plunged into recession. The unemployment rate in advanced economies began to rise owing to decreased aggregate demand amid budget consolidation, high public debt and financial instability.

Negative economic processes in DDCs had an adverse effect on DGCs as well. To that end, the main impact channels were low demand for export products of DGCs and high volatility of capital flows and commodity prices. For instance, low demand in the Eurozone and the USA resulted in slowdown both in Chinese export and investments – the key expenditure component of GDP. Besides pressures derived from foreign economic conjuncture, DGCs face domestic problems as well. Thus, in a number of countries investments decreased due to shrinkage of financial resources in some sectors of the economy.

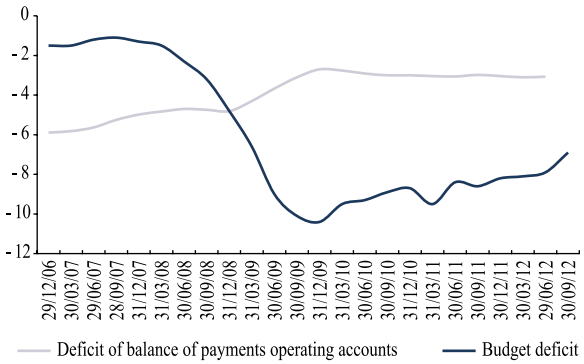
Chart 1.1. Growth rate of GDP
(annual percentage, consensus-forecast from 2012)



Source: Bloomberg

In order to prevent a new global crisis, nationally and globally coordinated measures were taken in 2012. Thus, a relevant law was adopted to mitigate the fiscal cliff threat and an adaptive monetary policy continued. The Federal Reserve System of the USA declared that it will continue the program on procurement of state treasury bills and mortgage securities. According to the recent resolution of the Federal System, the base interest rate will be maintained on a 0-0.25% level until unemployment rate drops down below 6.5% provided that the inflation rate is not over 2.5%.

Chart 1.2. State budget and current account deficit of USA, in % of GDP



Source: Bloomberg

Box 1. Financial sector regulation policy

In order to maintain the stability of financial system it is vital to ensure transparency, lower complexity and leverage ratio of markets and institutions. Therefore, a number of regulatory authorities strive to achieve their goals through new regulatory frameworks. For this purpose, reforms are conducted in various spheres.

The crisis was followed by more purposeful and more widescale financial sector regulation policy. Minimization of government financial aids to financial institutions of systemic importance to ensure taxpayers' interests, distorted evaluations of rating agencies and launch of Basel III are controversial issues.

Regulatory frameworks and their orientations

Name of the regulatory framework	Key directions
Basel III	Increase quality and quantity of capital
	Minimum Leverage ratio requirement
	Minimum Liquidity ratios requirements
	Higher capital requirement for contragent risk
New supervisory framework	Define micro and macro prudential supervisory thresholds, reduce procyclicity
	Supervision on regulatory bodies, independence and accountability
Additional capital requirements for global systemically important banks (too big to fail)	Mitigate potential impacts arising out of bankruptcy
	Reduce comparative advantage on financing of big banks in interbank market
Clearing of toxic assets	Centralized clearing system and standardization in the derivative market
	Separation of investment banking from retail banking
Reduce dependence on rating agencies	Enhance competition between rating agencies
	Avoid conflict of interest
Improvement of corporate governance	Increase the role of supervisory board and various committees
	Improve compensation policy
New taxes in the financial system	Obama tax: tax offer in the amount of 0.15 % of unstable liabilities of big banks
	Tobin tax for financial transactions: taxation offer to operations through shares and to derivatives (0.1% and 0.01% respectively) in EU
New entities and authorities to regulate financial stability	Globally: establishment of Financial Stability Committee
	Establishment of Financial Stability Supervision Board in USA
	Bank of England is in charge of the Financial Policy Committee and prudential supervision from 2013
	Assign unified supervision functions to the ECB from 2014

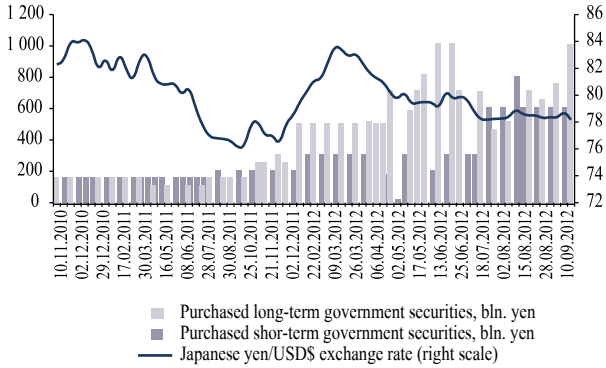
Source:

Ajay, A. (2012), Safeguarding financial stability. Course conducted from IMF institute, Vienna.

International Monetary Fund. (2012, October). Global financial stability report. Retrieved December, 2012, from IMF website.

The Bank of Japan has been continuously intensifying assets procurement program over the year. The program is under way until the end of 2013. The measures taken resulted in depreciation of the exchange rate of yen.

Chart 1.3. Purchase of government securities by the Bank of Japan and exchange rate dynamics of yen



Source: Bloomberg

The European countries also continued an accommodative monetary policy, and problematic countries and financial institutions of the continent were provided with financial support. Thus, the decision of international creditors "trio" on loan tranche to Greece positively affected investor confidence. Additionally, Eurogroup gave financial assistance to Spanish government due to the existing situation in the banking sector, which is to be channeled to recapitalization of some nationalized banks and also the problem of "bad assets" management. The measures taken to establish a common banking supervision mechanism in Europe to curb the banking crisis displays optimism for the future. The Eurogroup summit held on December 12-13, 2012 discussed implementation terms of this project, which implies formation of the new supervision mechanism in 2013 and enactment in 2014. The ECB will directly supervise Eurozone banks with assets above 30 billion euro or equal to 20% of GDP. Three biggest banks on each country will be supervised in a mandatory order, others by national supervisory authorities. In the event that the ECB reveals any problem in any bank, it will be entitled to intervene in that bank's activity. Also countries not in the Eurozone will be allowed to access the system.

At the same time, measures taken to restrict speculative movement of capital in some countries are worthy of note. France has already adopted the "Tobin tax" and some other countries are likely to take the same step. While the IMF follows liberal views on capital movement, recently it has acknowledged the necessity of measures on management of capital movement to maintain stability of the financial system under certain circumstances.

The measures taken resulted in subsided sovereign risks in the Eurozone that manifested itself in financial markets. Thus, the spread on bonds of Eurozone peripheral countries decreased, while some asset prices (particularly capital share tools) increased. As of the end of 2012 leading stock indices increased – S&P 500 – by 11.2%, Eurostoxx 600 – by 12.4%, MSCI Emerging Markets – by 11.6%, Nikkei 225 – by 20.6%. However, deteriorating global economic perspectives caused high volatility in international financial markets over the year.

Despite some positive trends, substantial risks over global financial stability are likely to remain in near perspective. Increase in budget crisis risk caused by difficulties related to the reforms to be carried out in the budget and banking system of the Eurozone, as well as risks arising out of tax-budget and lending policy in the USA might lead to next destabilization in the world economy in 2013. Europe, the USA and China are the major risk zones. Troubles of these countries may trigger global economic recession. Budget consolidation further magnifies probability of economic recession in a short-run causing higher debt and next budget sequester.

USA is likely to cut public expenditures USD 98 billion and increase taxes by USD 450 billion in 2013 in the event of failure to avert fiscal

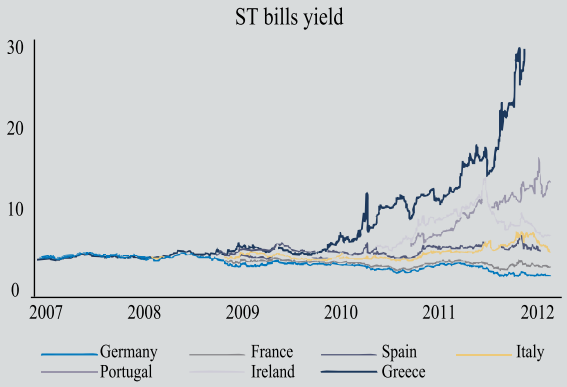
Box 2. Sovereign risk, European crisis resolution policies and bond yields

The Central Bank of Finland studied the impact of decisions related to European sovereign debt crisis on bond yields. Following the creation of the monetary union in 1999, yields on Euro area sovereign bonds began to converge rapidly, reflecting the elimination of inflation gap between countries and exchange rate risks. The period of convergence was followed by a few-year phase when sovereign bond yields remained stable and low amid divergent macroeconomic and fiscal developments in Euro area countries. Investors focus turned back to sovereign debt risks soon after the collapse of Lehman Brothers in September 2008. Public sovereign bond yields began to increase rapidly in countries with a weakened macroeconomic situation and fiscal position or otherwise had the banking sector that was particularly vulnerable to international financial crises (Greece, Ireland and Portugal). In contrast, in countries with stronger economic fundamentals (eg Germany, the Netherlands and Finland), long-term interest rates declined as a result of investors' flight-to-quality.

Euro area sovereign crises have led to a number of policy initiatives by the European fiscal authorities, including the decision to establish the European Financial Mechanism and the European Financial Stability Mechanism. At the same time, the ECB has used a series of non-standard policy measures: to mitigate existing tension in the financial system lowered its main policy rate to historically low levels. Enhanced liquidity support have included lengthening of the maximum maturity of refinancing operations, extension of the eligible collateral list, provision of liquidity in foreign currencies, and provision of unlimited liquidity at a fixed rate. In addition, the ECB has set up the Covered Bond Purchase Program (CBPP) and Securities Market Program (SMP) to purchase private and public bonds.

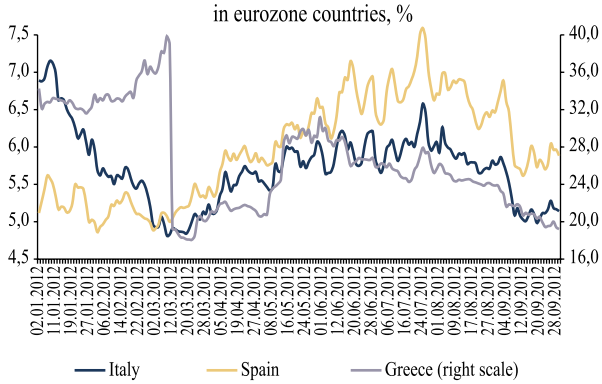
According to a survey, some of the impact of decisions taken in 2007-2012 had a material effect on bond yields resulting in lower risks in financial markets, the most essential decision being various Programs of the ECB on securities. The first program had a significant increasing effect on the bond market yields, while the second decision and elevated liquidity in sovereign bond market have not had lasting impact on bond yields.

The ECB interest rate decisions have mainly been anticipated in the markets, and lowering of the policy rate has led to a decline in the long term rate. The decisions on support packages have decreased yields in Greece, Ireland and Portugal, but increased the yields in Spain and Italy. On the one hand, the decisions related to creation and extension of European Stability Mechanism (ESM) have caused an increase in the yields in Germany, Ireland and Greece but no effects in other countries. On the other hand, other decisions, particularly the ones aimed at strengthening of economic growth, enhancing stability and fiscal discipline have not had significant lasting effect on public bond yields.



Source:
Kilponen J., Laakkonen H., & Vilmunen J. (2012) Sovereign risk, European crisis resolution policies and bond yields. Retrieved from Bank of Finland website: http://www.suomenpankki.fi/en/julkaisut/tutkimukset/keskustelualoitteet/Documents/BoF_DP_1222.pdf

Chart 1.4. 10-year government bond yield in eurozone countries, %



Source: Thomson Reuters Datastream

cliff. Automatic budget austerity measures in 2013 and 2015 may bring about 4% decline of GDP. In case of fiscal cliff scenario, global economic growth may decline by 1.2% in 2013. In that case, loss in production volume of DDCs may comprise about 1%.

Low demand in countries – importers of Chinese commodities pose lower economic growth risk for China. In case economic growth of China decreases by 5% over the year, production of DDCs may suffer 5% and the world economy 1.5% in 2013 – 2015.

1.2. Macroeconomic processes in Azerbaijan

In 2012 growth dynamics of the economy continued in the environment of favorable foreign position and strengthening of domestic demand.

The foreign position of the country remained favorable in 2012 amid global economic uncertainties. World prices of export products of Azerbaijan increased more rapidly than those of import products resulting in large surplus in trade balance.

According to the State Customs Committee, in 2012 foreign trade turnover made USD 33.6 billion USD, out of which USD 23.9 billion goes to the share of export and USD 9.7 billion to import. Export exceeded import 2.5 times and the surplus of the foreign trade balance constituted USD 14.2 billion.

In addition to export, remittances and foreign investments contributed to foreign exchange inflows as well during the year. According to preliminary data, the value of remittances to the country over the year made USD 1.837 billion increasing by 4% against the previous year. According to the SSC, the amount of foreign investments to the country economy climbed by 23 percent and exceeded USD 4.2 billion.

Foreign exchange reserves of the country exceeded USD 46 billion in 2012 having increased by 36% – sufficient for a three-year commodities and services import. Note that, only 20% of middle-income countries have sufficiency above 11 months. Foreign exchange reserves of the CBA made USD 11.7 billion having increased by 12%.

All components of the aggregate demand including the final consumption expenditures, investments and foreign demand had a positive effect on the economic growth. Growth in income of the population and domestic investments to the economy contributed to the revival of demand components of GDP.

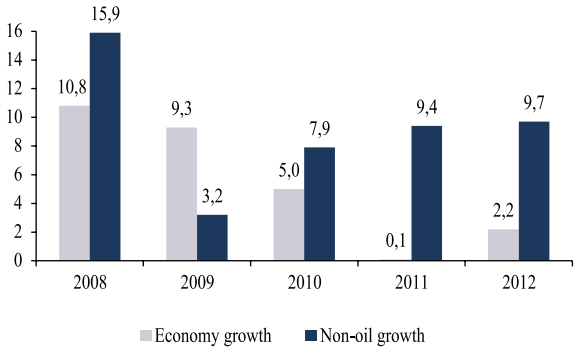
Ongoing growth of demand also manifests itself in the growth of commodity turnover and paid services. Retail turnover rose by 9.6%, including 21% increase in non-food retail turnover. Paid services to people grew by 8%.

In 2012 the GDP increased by 2.2% in real terms and reached USD 54 billion in nominal terms. In the reporting period the oil sector decreased by 5%, growth in the non-oil sector made 9.7% thereby making over 4 p.p. contribution to total growth. The share of manufacturing sector in the value added was 2/3, service sector 1/3.

The economy was macroeconomically stable and a single-digit level of inflation was maintained. Average annual inflation made 1.1% during the year.

In 2012 the CBA pursued its exchange rate policy within the framework of targeting bilateral USD/AZN exchange rate within the corridor. Supply exceeded demand in FX market in the

Chart 1.5. Economic growth, %



Source: SSC

environment of large surplus in the balance of payments of the country. However, in order to prevent considerable strengthening of manat in the FX market and neutralize negative impacts on the competitiveness of the non-oil sector the CBA sterilized USD 1584 million worth currency over the year. As a result, the exchange rate of AZN against USD strengthened at a moderate rate, only by 0.2% over the period. Exchange rate stability of AZN contributed to the macroeconomic environment and stability of the financial sector.

In 2012 money supply kept pace with the demand of the economy, money supply in manat gained by 25.5%, while money base increased by 27.1%. The structure of money supply continued to improve.

II. DEVELOPMENT OF THE BANKING SYSTEM

2.1. Dynamics of key indicators of the banking system

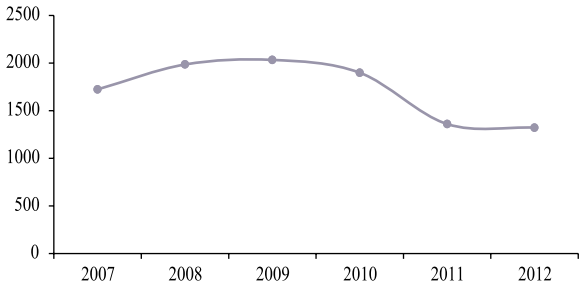
In 2012 the banking sector preserved growth dynamics and widened its financial intermediation.

As of end-2012 assets of the banking sector made AZN 17 643.4 million. Bank assets grew by AZN 3 696.6 million or 26.5% during the year. Loans rose by 27.8% and constituted AZN 12 399.4 million as of end-2012, which makes 70.3% of bank assets.

The deposit base of banks (funds attracted from financial and non-financial sectors) increased by 13.3%, including 24.1% rise in savings of individuals, that reached AZN 5 113.4 million.

The banking system is less concentrated. The share of large banks (top 5 in terms of the volume of assets) in systemic assets grew from 57% to 59.3%, while in credit investments it contracted from 56.5% to 55.4%. The dynamics of the Herfindahl-Hirschman index, widely applied in the international practice to evaluate the level of concentration of the banking system, displays medium concentration in the banking system as well.

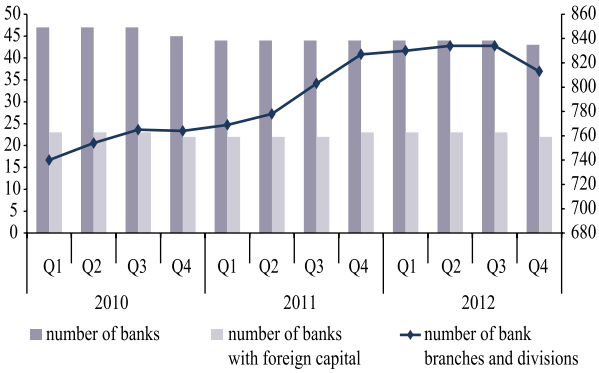
Chart 2.1. Herfindahl-Hirschman index



Source: CBA

As of the end of the reporting year, active banks were numbering 43. Banks opened 27 new branches (total 655) and 14 new divisions (total 158). The number of banks with foreign capital was 22 as of 1 January 2013.

Chart 2.2. Dynamics of the banking network



Source: CBA

Table 2.1. Growth rate of key indicators of the banking system, %

	2009	2010	2011	2012
Assets	13.6	13.9	7.3	26.5
Loans	17.3	9.0	8.1	27.8
Deposits of legal entities	-18.8	4.3	16.1	-0.2
Deposits of population	22.6	29.8	36.0	24.1
Aggregate capital	17.9	7.8	12.7	36.4

Source: CBA

Box 3. How much finance?

Recent studies suggest that a large-scale and complicated financial system may result in a serious crisis. In an even more recent paper, Gennaioli, Shleifer, and Vishny (2010) show that financial innovation can increase financial fragility even in case of low leverage.

Some studies have resulted in similar conclusions regarding relationship between financial depth and economic growth. For instance, our results show that the effect of financial depth on economic growth or output growth, to be exact, becomes negative if crediting to GDP ratio exceeds 80-100%. Two fundamental reasons prove this: i) economic volatility and increasing probability of great economic failures (Minsky, Kindleberger), ii) unfavorable allocation of economic resources (Tobin).

As known, crises are inevitable at times for the financial sector of the world economy. Even in some cases, resources required to restore financial sector are greater than benefits that the economy can gain from unstable financial sector. In particular, in terms of "too big to fail" concept, governments and central banks have to allocate large amount of resources to ensure the stability in financial and banking sector. Another fundamental reason – unfavorable allocation of resources intends to concentrate "talents" mainly in financial sector which leads to "talent" shortage in productive spheres on the one hand, and define investment orientations of financial resources on the other hand. Investments in productive assets and speculative bubble bearing real estate are among those orientations. Thus, a survey (Beck) conducted in 45 countries in 1994-2005 revealed the interdependence between loans to private sector and economic growth, but no correlation between loans to households and economic growth.

Source:
Arcand J., Berkes E., & Panizza U. (2012). Too much finance? (Working Paper No. 12/161).
Retrieved from IMF website: http://www.imf.org/external/pubs/ft/wp/2012/wp12161.pdf

The number of NBCIs shifted to 133 from 125. As of the end-2012, credit unions were numbering 104, while the number of credit institutions financed by international humanitarian institutions was 28. The number of their branches reached 102 as of 1 January 2013 (74 as of 1 January 2012).

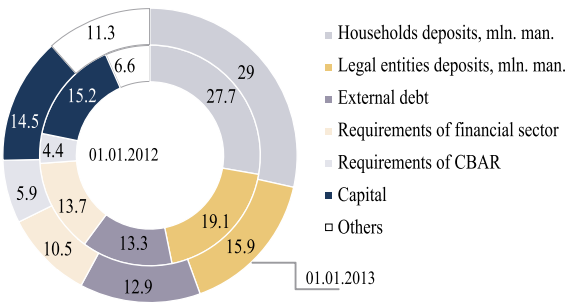
63 branches of the AZERPOST LLC, which provides banking-financial services to the customers in regions and continuously expand its activity scope, operated successfully during the year. As of 1 January 2013 departments of AZERPOST LLC were numbering 945 (y.o.y. 867).

2.2. Liabilities of the banking system

In 2012 the resource base of the banking system primarily stemmed from the funds attracted from the domestic market.

In 2012 banks' liabilities rose by 27.6% (AZN 3 259.8 million) and made AZN 15 088.1 million. Also, banks' total deposits rose by 13.3% and reached AZN 10 699.2 million and took 71% of total liabilities.

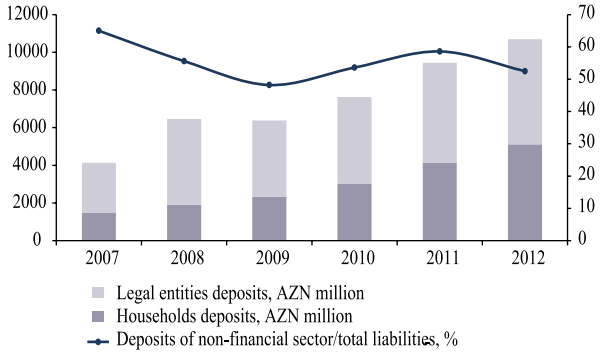
Chart 2.3. Structure of banks' resource base, %



Source: CBA

In 2012 deposits of the population increased by 24.1% and equaled AZN 5113.4 million that makes 34% of total bank liabilities as of end-period.

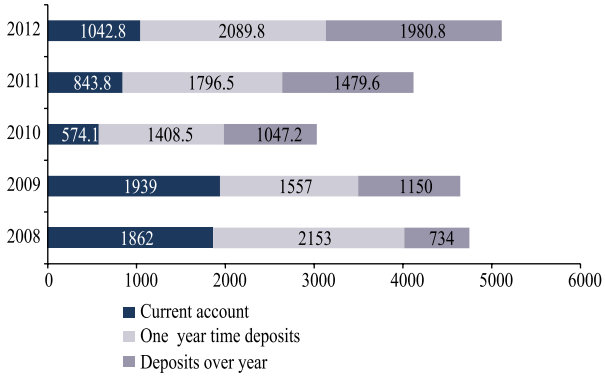
Chart 2.4. Dynamics of deposits of non-financial sector



Source: CBA

In 2012 the term structure of deposits followed positive trends. Term deposits reached AZN 794.5 million, while demand deposits grew by AZN 199 million. The share of term deposits in total deposits made 80% as of yearend.

Chart 2.5. Term structure of deposits, AZN million



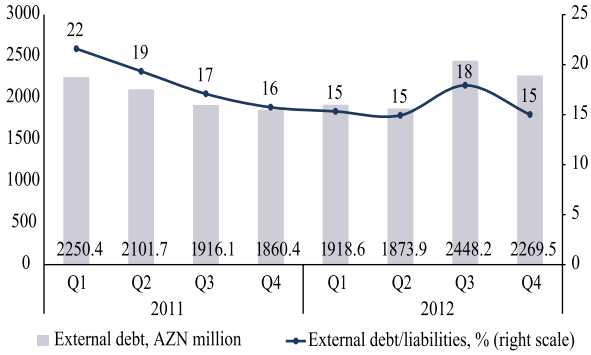
Source: CBA

High confidence of the population in the banking system manifested itself in continuous rise in long-term deposits and in deposits in the national currency. Over the reporting year long-term deposits rose by 33.9% and made 39% of total deposits. In 2012 deposits in the national currency having increased by 30% reached AZN 2 963.9 million and made 58% of total deposits.

The size of deposits of non-resident individuals grew by 58% and made 12% of total deposits.

Deposits of legal entities (financial and non-financial institutions) grew by 4.9% and reached AZN 5 585.8 million as of 1 January 2013. Legal entities preferred term deposits, which grew more rapidly than demand deposits. Term deposits rose by 9.5%, while demand deposits dropped by 0.1%. The share of term deposits in total deposits of legal entities was 54%.

Chart 2.6. Dynamics of external debt



Source: CBA

The Azerbaijani economy and banking system remained attractive for foreign investors. The size of funds attracted from non-resident banks and international financial institutions made AZN 2 269.5 million as of the yearend. Besides, the funds attracted from abroad were on an acceptable level and amounted to 15% of total deposits.

Decrease in dependency of banks on foreign resources and replacement of external funds with internal deposits raised banks' resilience to external shocks and triggered financing of loans through more stable resources.

Box 4. Financial literacy

Improvement of financial literacy of the population has become more important in last 10-15 years, in particular after financial crises. The term "financial literacy of the population" is interpreted in different ways. Generally, a financially educated person is a person with sufficient knowledge to take sound decisions on use of financial services. On the one hand, modern financial services better customers' quality of life (life insurance, non-governmental pension funds, deposit insurance, etc), however, on the other hand, some people can not use financial products efficiently due to lackage of necessary financial knowledge. Continuously growing modern financial markets offer new products and attract customers. In most cases, users of these services can not fully understand the risks and costs that they bear. Customers pay attention to user manual of a product only after risk factors emerge while using a product or as a result of comparative evaluation. At the same time, a financial institution in some cases does not provide detailed or otherwise any information on changes to rules of employment of financial services. As a result of information deficiency or absence of information, people do not fulfill their liabilities to financial institutions. Financial illiteracy has a negative impact not only on the well-being of customers, but also on the stability of financial markets.

The World Bank conducts surveys amongst financial services customers in order to evaluate and monitor the financial literacy level in various income countries. The surveys mainly cover the following questions:

- read the contract before acquiring a financial product and understand terms used in the contract;
- compare prices of the same products offered by various companies;
- revenue-expense budgeting;
- how much customers feel protected in case of a conflict with a financial institution;
- awareness on details of public insurance of deposits and of types of assets insured, etc.

The results of surveys in a variety of countries show that the majority of population does not read the contract when purchasing a financial product and only 2 out of 5 persons fully comprehend contract information. Only 4 out of 10 persons compare purchased product terms and conditions with those of the same product offered by other providers. 3 out of 4 persons have no confidence in fair resolution of the conflict with the financial institution. This is related to depositors' unawareness of their rights and violation of their rights in the financial market.

A number of countries (England, USA, Canada, Australia, Poland and Germany) are implementing national programs in order to improve financial literacy of the population.

The Central Bank of the Republic of Azerbaijan has also started the process and held 25 series of events jointly with commercial banks, international organizations, and public entities. The World Savings Day took place for the first time last year. The concept of the financial literacy portal has been developed. Systematic measures regarding strengthening financial literacy of the population (launch of financial literacy portal, implementation of exchange of knowledge and virtual central bank projects, etc) are to be continued in 2013 as well.

Source:

Central Bank of the Republic of Azerbaijan (2012). Central Bank initiates World Savings Day [Press release]. Retrieved from: http://www.cbar.az/releases/2012/11/30/central-bank-initiates-world-savings-day/

Klapper L., Lusardi A., & Panos G.A. (2012). Financial Literacy and the Financial Crisis (Working Paper No. 5980). Retrieved from World Bank website: http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2012/02/29/000158349_20120229095430/Rendered/PDF/WPS5980.pdf

Xu L., Zia B. (2012). Financai Literay around the World: An Overview of the Evidence with Practical Suggestions for the Way Forward (Working Paper No. 6107). Retrieved from World Bank website: http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2012/06/27/000158349_20120627090058/Rendered/PDF/WPS6107.pdf

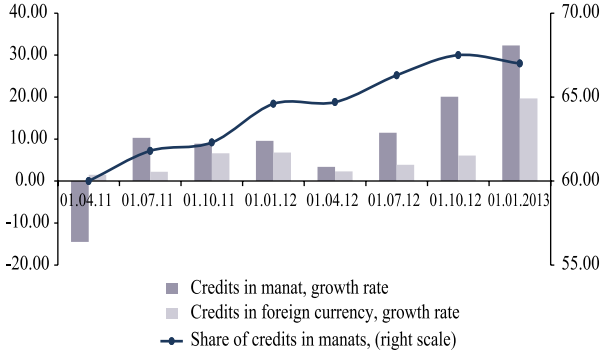
2.3. Assets of the banking system

During the reporting year the banking system continued to financially support the economic activity and positive changes were observed in the structure of banks assets.

In 2012 growth in bank assets made 26.5% which primarily sourced from credits. Credits rose by 27.8% over the reporting year and amounted to AZN 12 399.4 million.

According to the CBA survey, demand of the population and business subjects for lending was high. As in previous periods, SME's demand for lending rose as well. Long-term loans have become more attractive for the corporate sector. High supply for business loans mainly relates to banks' high credit demand expectations, and subdued interest rate and collateral depreciation risks.

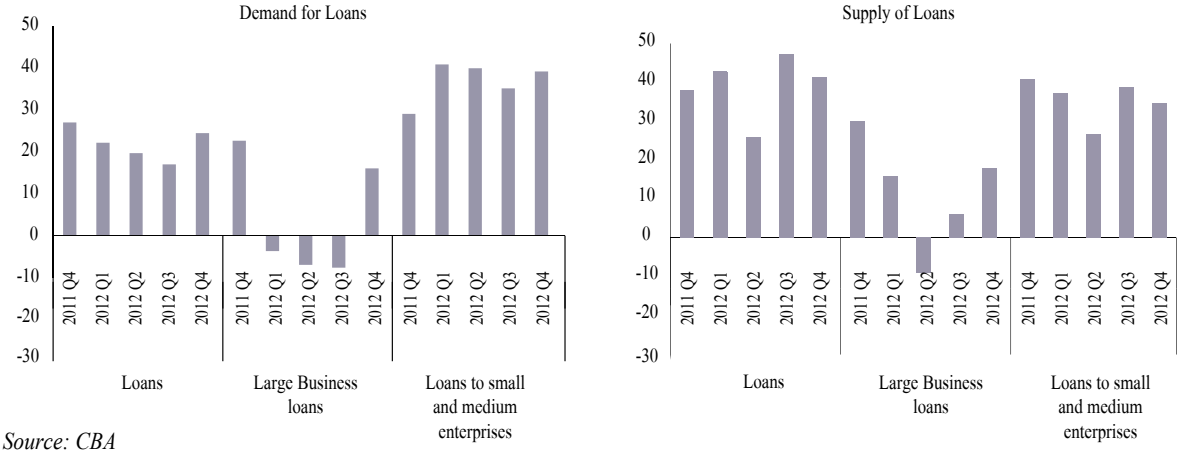
Chart 2.8. Currency structure of lending portfolio, %



Source: CBA

Over the reporting year, the growth rate of the loans in the national currency (32.3%) prevailed over that of the loans in a foreign currency (19.7%). As a result, the share of loans in AZN in the lending portfolio increased by 2.3 p.p. and made 67% as of the yearend.

Chart 2.7. Supply and demand for business loans (results of a credit survey[1])



Source: CBA

Over the year, credit growth stemmed from long-term loans. Thus, short-term loans rose by 27.4%, while long-term loans grew by 28.1%. The term structure of the lending portfolio remained roughly stable during the year. As of 1 January 2013, the share of long-term loans in the structure of the lending portfolio made 70.6% and the share of short-term loans made 29.4%. (70.5% and 29.5% respectively - January 1, 2012).

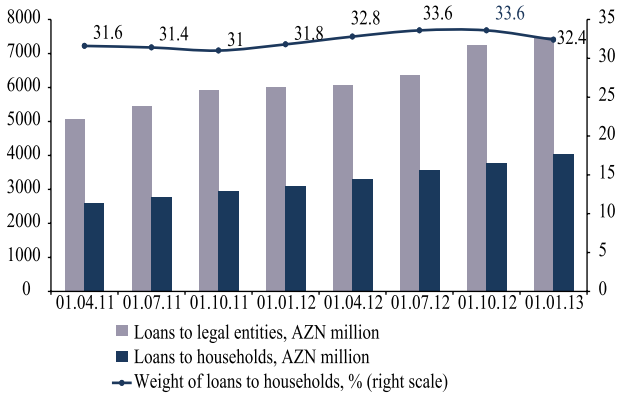
Loans to legal entities by banks grew by 15.2% during the year and made AZN 7 467 million (60.2% of the portfolio).

Over the reporting year, loans to households (by banks) grew by 30.1% and constituted AZN 4 014.3 million.

During the year real estate purchase and construction loans to individuals increased by 22.2% and as of January 1, 2013 constituted AZN 703.7 million. The share of these loans in the portfolio of household loans was 16.2%.

[1] Note – the result of the survey is calculated by the net percentages method by focusing on the difference (net percentage) between the share of banks reporting the increase (ease) and the share of banks reporting the decrease (tightening) to the questions that were asked to them. The positive net percentage indicates the increase (ease) and the negative percentage indicates decrease (tightening).

Chart 2.9. Dynamics of structure of the lending portfolio by subjects



Source: CBA

Loans to individuals engaged in entrepreneurship activities rose by 14.5% and took 6.9% of household loans.

The share of long term loans to individuals (on all credit institutions) in total portfolio posted a 5 p.p. growth and took 76% (AZN 3 268.7 million) of the portfolio. Household loans made 1/3 of the portfolio as of the yearend.

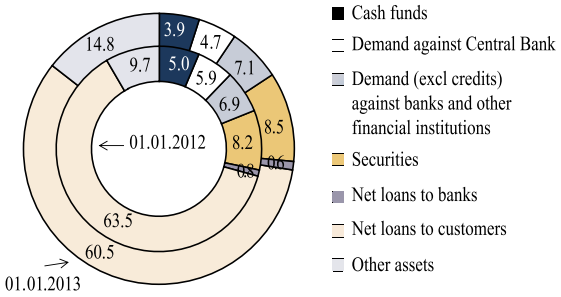
Loans to engineering and natural resources rose by 71%, agriculture and manufacturing by 17.1%, transport and communication by 96,7%, industry and production by 122.6%, construction and property by 45.1%, while loans to trade and services fell by 6.9%.

Growth on loans on credit card operations was 29.9% over the reporting year.

In 2012 credit institutions kept regional crediting. Credit investments to regions over the year increased by 21.6%.

As in previous periods, loans to regions in the national currency prevailed over those in the foreign currency and as of January 1, 2013 took 74% of the lending portfolio. Long-term loans to regions were 69% of the total loans to regions.

Chart 2.10. Structure of bank assets, %



Source: CBA

In the reporting year, bank investments to securities rose by 32% and reached AZN 1 503.6 million as of January 1, 2013 (AZN 1 139.3 million as of January 1, 2012).

Table 2.2. Sectoral structure and dynamics of banks' lending portfolio

Sector	01. 01.13		Growth over the year, %
	AZN million	Share in lending portfolio, %	
Trade and services	2 648.2	21.4	-6.9
Households	4 014.3	32.4	30.1
Agriculture and manufacturing	535.4	4.3	17.1
Construction and property	1 270.3	10.2	45.1
Industry and production	1 297.7	10.5	122.6
Transport and communication	805.9	6.5	96.7
Engineering and natural resources	496.7	4	71.5
Other	1 331	10.7	15.2

Source: CBA

Box 5. Mortgages and risks

Like other banking transactions, mortgages, essential financial products which play a role in improving housing conditions of population and developing the construction sector, are exposed to some risks. The reasons for these risks that are quite abundant are macroeconomic situation, standards of living, economic policy of the government, application of new investment-credit technologies and tools, changes in prices of real estate, etc. Mortgage risks mainly include:

Credit risk – borrower's failure to fulfill his/her liabilities under the loan contract. While it is impossible to prevent this risk completely, it can be mitigated through sound evaluation of property value and creditworthiness of the borrower, creation of a reliable system on registration of property rights, attraction of public guarantees on mortgages, classification of loans on risk groups, determining problem loans in a short time, preparation of repayment programs, and establishment of reserve funds. At the same time, this type of risk can be mitigated provided that monthly payment per member of the family to monthly income ratio is not above 25-45% or the amount of the loan do not exceed 50-85% of the market value of the property used as a collateral.

Interest risk – emerges when interests paid on resources attracted by credit institutions exceed interests paid on loans. Interest risk stems from impossibility to forecast interest rate changes. Interest rate fluctuations (often after inflation) lead to a decline in yields on mortgages for creditors and probability for premature repayment of loan (the borrower repays the loan before maturity to be able to get loan with lower interest rate later).

Liquidity risk – results from changes in market conditions, interest rates, exchange rate and stock exchange, as well as gaps (in the event the resource base on mortgages primarily stems from short-term assets) in the structure of bank assets and liabilities, etc.

Market risk – results from sharp decline in real estate prices in the property market.

Exchange rate risk – results from exchange rate fluctuations. A borrower (if loan is in a foreign currency, while income of the borrower is in the national currency) is exposed to the risk of the type.

Disability risk – refers only to the borrower and in case of disability risk the borrower can not accomplish his/her credit liabilities. In that case demand on collateral realization arises.

Premature loan repayment risk – if realized, the creditor receives large amount of money to be reinvested. The interest rate may be lower when reinvesting.

Property risk – relates to collateral, results from damage to property or loss of property title.

In the international practice, the above risks are primarily mitigated through mortgage insurance. A number of countries apply three types of insurance in the mortgage market in a mandatory order:

- life and health of the borrower;
- loss of or damage to property;
- loss or limitation of property title over collateral.

While people were somewhat cautious on this type of loans in the past, nowadays every family without own housing thinks of mortgage, possible upon development and application of public mortgage subsidizing programs that assist various segments of population to buy a flat.

Source:

Rossi C. V. (2010). Anatomy of Risk Management Practices in the Mortgage Industry: Lessons for the Future. Retrieved from Research Institute for Housing America website: http://www.housingamerica.org/RIHA/RIHA/Publications/72939_9946_Research_RIHA_Rossi_Report.pdf

Table 2.3. Loans and deposits on regions (excluding Baku), AZN million

Date	Credit investment			Deposits		
	Total	In AZN	In foreign currency	Total	In AZN	In foreign currency
01.01.2012	1 271.7	940.1	331.5	327.6	242.7	85
01.04.2012	1 273.4	972.1	301.3	386.9	270.2	116.7
01.07.2012	1 398.7	1 075.5	323.2	381.7	287.8	93.9
01.10.2012	1 372.9	1 020.8	352.1	360.9	279.2	81.3
01.01.2013	1 546.1	1 144.5	401.6	359.1	270.7	88.4

Source: CBA

2.4. Financial results of the banking sector performance

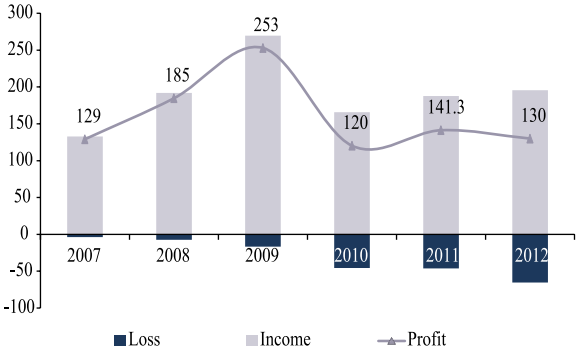
Over the year, banking system's overall financial results were positive.

In 2012, banks generated AZN 169.9 million worth profit. Net profit after taxes made AZN 130 million.

The number of banks operating with profit and loss were respectively 33 (31 as of 01.01.2012), and 10 (13 as of 01.01.2012).

Revival of credit performance and stabilization of asset quality contributed to growth in profits of the banking system which manifested itself in high interest income and low reserve oriented resources.

Chart 2.11. Profit of the banking system, AZN million



Source: CBA

Over the year banks' interest income on loans to customers rose by 13.6% (total AZN 1 149.1 million interest income on loans to customers). The y.o.y. decrease in the interest income to average assets ratio was 0.2 p.p. and made 7.5% as of the end-period.

The y.o.y. increase in income from other interest bearing assets (interbank exposures, investments and financial leases) was 23.4% and its ratio to average assets remaining stable made 0.7%. In 2012 y.o.y. increase in total interest income was 14.4% (AZN 158 million) and reached AZN 1 257.8 million as of January 1, 2013.

The y.o.y. increase in banks' total non-interest income was 14.4% and as of the yearend constituted AZN 367.3 million. Rise in net income from foreign exchange operations and commissioning fees for other services contributed to this increase.

Banks' overall total income (interest and non-interest) made AZN 1 625.1 million, y.o.y. increase being 14.4% (AZN 204.3 million). Interest income contributed to total income increase by 11.1 p.p., non-interest income by 3.3 p.p. (in 2011, 3.4 p.p. and 3.7 p.p. respectively).

The y.o.y. increase in interest expenses was 12.7% and made AZN 661 million, which primarily stemmed from rise in interest expenses on term deposits of individuals. The y.o.y. decline in ratio of interest expenses to average assets being 0.3 p.p. made 4.2%. The y.o.y. increase in non-interest expenses was 18.1% and as of January 1, 2013 made AZN 635.9 million. The non-interest expenses to average assets ratio remained unchanged and made 4.1%. The y.o.y.

increase in banks' total expenses (interest and non-interest) was 15.3% (or AZN 172.2 million) and constituted AZN 1296.9 million. Interest expenses contributed to total expense increase 4.7 p.p. (2.9 p.p. in 2011), non-interest expenses 6.1 p.p (7.2 p.p. in 2011).

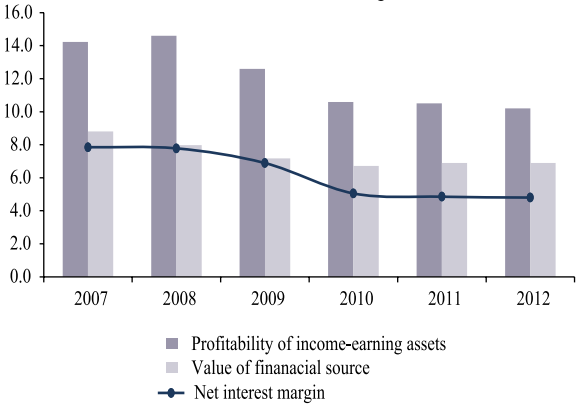
Amid stabilizing credit risks decrease in expenses channelled to loan loss provisioning was AZN 287.5 mln (64.3%), which has a positive impact on drop in total expenses of the banking system. Expenses channeled to creation of reserves on assets contributed to decline of total expenses by 18 p.p. (4% in 2011).

In 2012 operational profit of banks was AZN 328.3 million.

The y.o.y. increase in ROE was 16 p.p. and constituted 7.1%. Decline in the level of ROE resulted from stabilization of assets' quality and low deductions to loan reserves. The y.o.y. increase in ROA was 2 p.p. and made 0.8%.

Decremental trend of ROA in recent years results from decline in net interest margin. Moreover, dynamics of net interest margin demonstrates some stabilization. Thus, y.o.y. decline in net interest margin was slight (0.1 p.p.) and made 4.8%.

Chart 2.12. Net interest margin, %



Source: CBA

Decline in net interest margin primarily stemmed from increase in term deposits of individuals and legal entities and decrease in yields of relatively cheap external resources and income bearing assets.

Table 2.4. Structure of profit, AZN million

	2011	2012	Change, %
Interest income	1 099.8	1 257.8	14.4
Interest expense	586.3	661.0	12.7
Non-interest income	321.0	367.3	14.4
Non-interest expense	538.4	635.9	18.1
Total income	1 420.8	1 625.1	14.4
Total expense	1 124.7	1 296.9	15.3
Net operation profit	296.0	328.3	11.0
Deductions to loan loss provisioning	447.3	159.7	-64.3

Source: CBA

Generally, in recent 2 years, yields of income bearing assets and cost of financing sources have been stabilizing (10.2% as of yearend).

2.5. Capital of the banking sector

Over the reporting year the banking sector has kept strengthening the capital base and capital adequacy indicators of the system have maintained an acceptable level.

In 2012 the size of banking system's aggregate capital rose by 36.4% or AZN 686.9 million and as of the yearend reached AZN 2 573 million. Rise in the aggregate capital primarily (81.6%) sourced from authorized capital. The authorized capital grew by AZN 540.8 million

Table 2.5. Structure of bank capital, AZN million

	01.01.2012	01.01.2013
Authorized capital	1 558.9	2 099.7
Share premium	20.7	20.7
Retained net profit (loss)	-40.7	-80.8
Profit of current year	163.5	195.6
General reserves	159.5	190.9
Other funds of capital	151.5	302.6
Aggregate capital	1 886.2	2 573.1
Deductions from capital	-119.5	-155.5

Source: CBA

Box 6. The impact of bank capital on profitability and risk in Asian banking

New regulations (Basel III) accepted by Basel Committee on Banking Supervision in response to recent financial crisis determine higher capital requirements for banks. A special investigation has been carried out to measure banking capital growth as in the case of the Asian banking system (2276 banks from 42 countries).

The impact of banking capital on profitability and risk can be viewed in terms of various hypotheses. According to regulatory hypothesis, as risks increase in the banking system, regulators require to increase capital, thereby ensuring optimal balance between banking capital and risk. In contrast, according to moral hazard hypothesis, in case of capital decrease (increase), banks increase (decrease) risks using deposit insurance. In addition, according to financial theory, growth of banking capital increases profits by minimizing insurance expenses on uninsured liabilities and interest expenses on attracted liabilities.

The results of econometric analysis suggest that capital growth generally has an increasing effect on profit, but decreasing on risk. Moreover, 3 significant results of the research are worthy of note. First, while an increasing effect of banking capital on profit is stronger in investment banks, it has decreasing effect on risk in commercial banks. Second, impact of banking capital on profit and risk varies according to countries' level of income. Thus, increasing impact of banking capital on profit is stronger in low-income countries. Decreasing impact of banking capital on risk is stronger in countries with low-medium income level compared to other countries. The smallest impact of banking capital on profit (increasing) and risk (decreasing) has been observed in high income countries. According to Claessens, (2009) sound financial supervision and Hi-Tech in high income countries result in lower risks and therefore capital growth does not mitigate risk considerably. To sum up, relationship between banking capital and profit (positive) is stronger in the Middle East, however relationship between banking capital and risk (negative) is stronger in Central Asia and Far East.

Note that, Azerbaijani banks were also included in the research and the results demonstrate that growth of Azerbaijani banking capital contributes to the financial stability. Thus, banking capital growth has maximum subsiding effect on risk in the income group Azerbaijan is the part of.

Source:
Lee, C. C., Hsieh, M. F. (2012). The impact of bank capital on profitability and risk in Asian banking. Journal of International Money and Finance

or by 34.7%. Total reserves have risen by 19.8% (AZN 31.5 million) since the beginning of the year. Investments to shares of subsidiaries and other credit institutions, and intangible assets was AZN 302.6 million (AZN 151.5 million in 2011).

Capital adequacy on the banking sector was far above the threshold and as of the end-period made 16.8%.

In 2012 Tier I capital adequacy having increased 1.2 p.p. made 12.9%, which is twice above the threshold (Tier I capital adequacy ratio 6%).

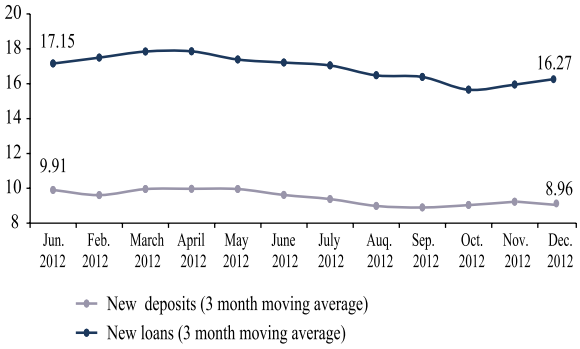
2.6. Interest rates in banks

In 2012 average weighted nominal interest rates on loans and deposits in manat and a foreign currency declined.

The y.o.y. decrease in average interest rates on loans in manat was 1.2 p.p. and made 15.1%. The y.o.y. decrease in average nominal interest rates on deposits in manat shifted to 10% from 10.3%. Interest rates on loans and deposits in a foreign currency declined by 1.2% and 1%, respectively. Interest margin in manat was 5.1% on average and 5.5% in foreign currency.

Average weighted interest rates on newly issued loans, attracted deposits and interbank loans declined over the year.

Chart 2.13. Interest rate on new deposits and loans in manat



Source: CBA

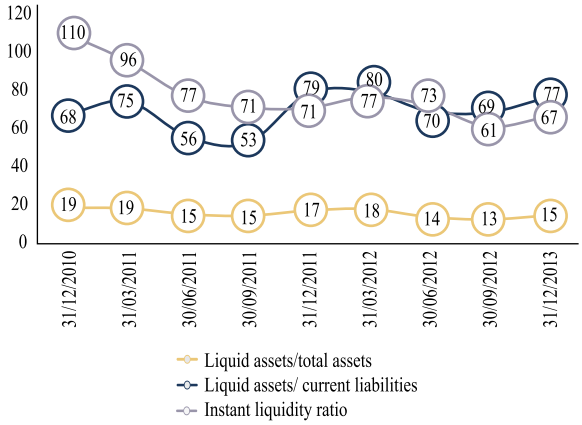
As of the end of 2012 the y.o.y. decline in interest rates on interbank loans in manat was 0.71 p.p. and made 9.15%, while in a foreign currency this indicator equaled 5.6% upon a 2.39 p.p. decline.

III. RISKS IN THE BANKING SYSTEM

In 2012 risks in the banking system were maintained at manageable level. The maturity gap analysis of assets and liabilities suggests acceptable liquidity in the banking system.

In 2012 banks' liquidity level was acceptable. While the scale of highly liquid assets slightly declined (2.5%) due to recovery of the lending activity, the liquid assets to total assets ratio was above the threshold (10%). The share of liquid assets in current liabilities dropped slightly. The instant liquidity ratio was 66.8% which is above the CBA's threshold (30%).

Chart 3.1. Liquidity indicators, %

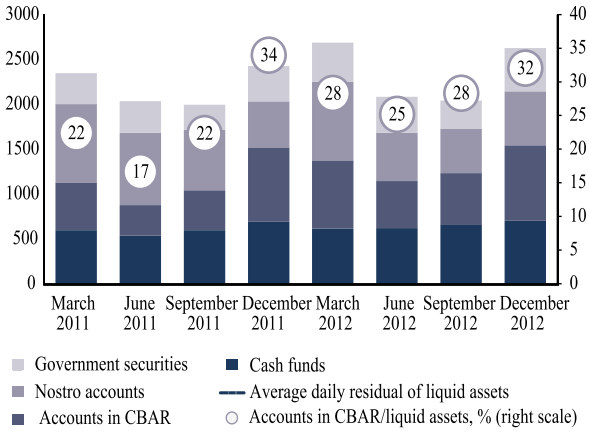


Source: CBA

The y.o.y. average daily balance of highly liquid assets rose AZN 95.6 million (4.7%) and reached AZN 2 145 million.

As of 01.01.2013 the share of cash funds, nostro accounts and government securities in the structure of highly liquid assets was 27.7%, 23% and 18.3%, respectively. The share of banks' accounts with the CBA in liquid assets made 32% as of the end-period.

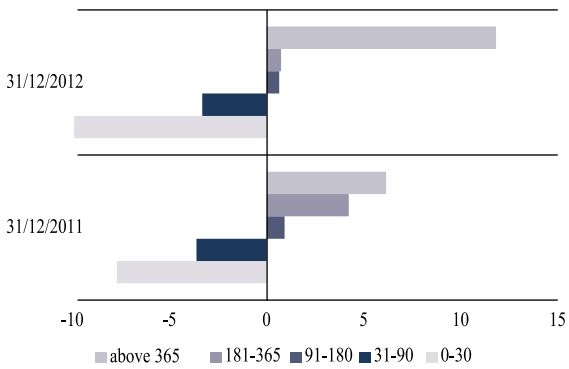
Chart 3.2. Dynamics and structure of liquid assets, AZN million



Source: CBA

Over the period banks' maturity gap on assets and liabilities was at manageable level.

Chart 3.3. Gap between assets and liabilities to assets ratio, %



Source: CBA

In 2012 the quality of the lending portfolio was on an acceptable level. The share of overdue loans in total loans made 6.5%.

In general, CBA's regular stress-tests demonstrate that the Azerbaijani banking sector is resilient to extreme macroeconomic shocks.

Box 7. Anti-crisis mechanisms in the banking system

As a result of incremental crisis and stress cases in the financial-banking system, the issue of application and improvement of anti-crisis mechanisms becomes much more vital for regulatory entities. To that end, prevention of any panic among population, uninterrupted functioning of settlement-payment systems and minimization of losses of creditors are of paramount importance.

Liquidity support mechanisms: Recent global financial crisis stemmed from liquidity crisis. Under such circumstances, a number of central banks, particularly the Fed, and the European Central Bank have taken substantial measures to increase liquidity injections to the banking system. The measures cover issues, like increasing the volume of refinancing transactions of central banks, prolongation of loans to commercial banks, extension of assets used as a guarantee, etc

Prevention mechanisms against panic (outflow of deposits from the banking system) amongst depositors: Anti-crisis management practice demonstrates that deposits insurance systems are the most efficient means for prevention of panic amongst people, and maintenance of confidence in the banking system.

A number of DDCs and DGCs have applied similar systems in recent 20 years. Deposits insurance is the system that allows individuals to withdraw their deposits in the event the bank lisence is revoked or the bank goes bankrupt. For this purpose, deposit taking banks make relevant payments to the qualified entity (insurance fund) and if necessary, the insurance fund, in its turn, returns depositors' money back.

In spite of some differences among countries on deposits insurance mechanism, there are common deposit insurance principles:

- compulsory involvement of deposit taking financial institutions in the insurance system;
- mitigation of depositors' risks in the event of failure of liabilities of deposit taking financial institutions;
- transparency of insurance fund activity;
- cumulative nature of insurance fund assets.

The first compulsory insurance fund on protection of deposits of individuals was established in 1933, during the Great Depression in the USA. Deposit Insurance Federal Corporation initially payed USD 5000 at maximum to each depositor. The amount of compensation increased 50 times from that time on.

According to the information of international Association on Deposit insurance, deposit insurance systems are currently in function in 112 countries. As a result of efficient functioning of insurance funds, there has been no need to take severe measures, such as application of moratorium in payment of liabilities.

One of the important measures on prevention of panic amongst people, maintenance of confidence in the banking system is to reduce the compensation amount on deposits. Thus, the insurance amount in the USA has shifted to USD 250 thousand from USD 100 thousand in recent years. In EU the amount has risen form Euro 20 thousand to Euro 50 thousand (up to Euro 100 thousand from December 31 2010.

Capitalization of the banking system: Subordinated loans were an important measure to ensure sustainability of the banking system during the crisis. Subordinated loans to commercial banks by a central bank and relevant public entities facilitate to maintain the capitalization of banks on an acceptable level, as well as avert direct nationalization. According to international practice, subordinated lending and purchase of preferred shares are considered to be useful for the capitalization of banks that are capable to resolve problems with respect to the crisis. Thus, public investments allow these banks to temporize attraction of private capital with acceptable terms in future. Banks with tough problems and no capacity to resolve them are recapitalized through purchase of bank's common shares by the government.

Source:
Udaibir S. D., Quintyn M. (2002). Crisis Prevention and Crisis Management: The Role of Regulatory Governance (Working Paper No. 02/163). Retrieved from IMF website: http://www.imf.org/external/pubs/ft/wp/2002/wp02163.pdf
Garcia G. (2000). Deposit Insurance and Crisis Management (Working Paper No. 00/57). Retrieved from IMF website: http://www.imf.org/external/pubs/ft/wp/2000/wp0057.pdf

Capital adequacy remains sustainable. In parallel, market and liquidity risks are improving. Credit risks are on a manageable level.

IV. PAYMENT SYSTEMS

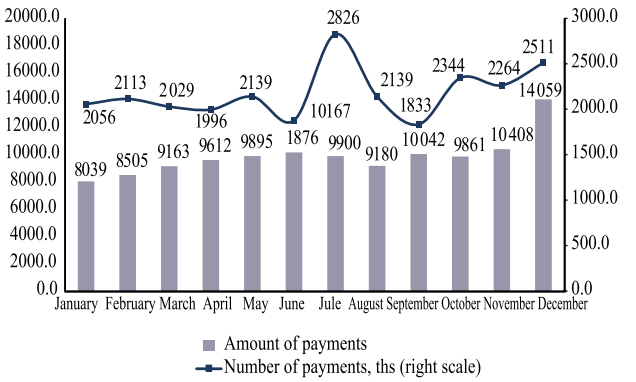
Over the reporting year payment systems ensured stable and uninterrupted operation. The scale and the number of transactions in the National Payments System adequately responded to the economic activity in the country.

In 2012 AZN 118 849 million worth 26 126 million pcs of transactions were conducted in the National Payment System. The y.o.y. increase in the number of transactions was 33.6% (6 565 thousand pcs), and in total volume was 10.2% (AZN 11 001 million).

Average daily number of transactions over the reporting year was 99 thousand, average daily volume AZN 450.2 million (y.o.y. 74.1 thousand pcs and AZN 408.5 million respectively).

Out of cashless payments 90% was made through the AZİPS system, total volume of which constituted AZN 107 003 million (495 thousand pcs of transactions). The y.o.y. increase in transactions was 7.8% (AZN 7 724 million). The amount per payment order on average equaled AZN 222.5 thousand.

Chart 4.1. Dynamics of payment transactions in the National Payment System



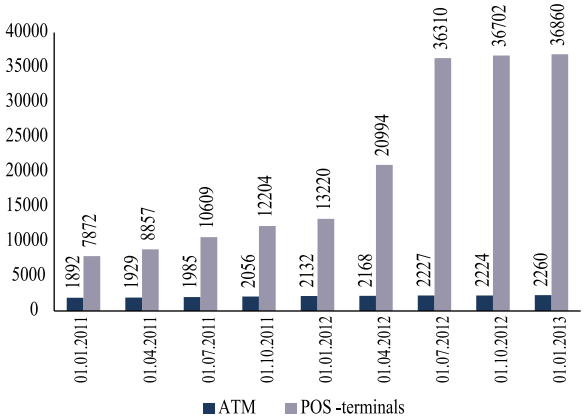
Source: CBA

10% (AZN 11 846 million) of payments were made through the BCSS in terms of amount. The share of the BCSS in terms of quantity made 98.1% and as of the end of the reporting year constituted 25 631 million pieces of payments, that surpassed the previous year by 38.2% (AZN 3 277 million) in terms of volume and 33.8% (6 468 thousand pcs) in terms of number. The amount per payment order on average equaled AZN 463.1.

Commercial banks continued developing plastic card servicing infrastructure. As of the end of 2012 plastic cards were serviced via 2 260 ATMs and 36 860 POS-terminals across the country. Note that, the y.o.y. increase in the number of ATMs and POS-terminals was 7% and 2.8 times respectively.

In 2012 AZN 7 630 million worth 48.798 million transactions were conducted via ATMs. The number of POS-terminal transactions was 4 672 thousand pieces and the volume made AZN 599 million.

Chart 4.2. The number of installed ATMs and POS-terminals



Source: CBA

Box 8. Payment infrastructure in Azerbaijan

The Central Bank is mandated to ensure uninterrupted operation of payment systems and nurture development of these systems in the country.

Significant progress has been made in this sphere and modern infrastructure compatible with the international standards created in recent years. The architecture of the payment system of the country includes:

- Large-value Payment System (RTGS)
- Retail Payment System (BCSS)
- Centralized Information System on Mass Payment (CISMP)
- Government Payment Portal
- Card processing institutions
- Card processing centers

One of the significant achievements in the payment architecture in 2012 was transition to the common customer account structure – completion of the IBAN project. This system is currently being used in 61 countries.

High growth dynamics has been observed in the turnovers of electronic payment infructructure in recent years.

The size of payments on Large-value Payment System (RTGS) grew by 50% over the past 5 years and made AZN 107 billion – twice as much of GDP. The size of payments on Retail Payment System (BCSS) doubled and made AZN 12 billion.

The payment cards market is evolving rapidly. The number of plastic cards grew by 38% over the past 5 years, and the size of domestic transactions through cards reached AZN 8.2 billion 51% of cards are social cards. The number of ATMs rose by 49%, that of POS-terminals 4.5 times.

Centralized Information System on Mass Payment (CISMP) launched in 2008 presented a wide range of opportunities to pay utility fees, taxes and duties, insurance fees and others electronically. The size of electronic payments in CISMP increased 2.6 times over the past 3 years.

One of the latest projects is the Government Payments Portal established on the CISMP platform. The portal provides direct payments of taxes, duties, rentals and other payments to public entities and eliminates their off-bank payment in cash. Currently, relevant public entities are integrating into this portal that includes 41 banks, AzerPost LLC, 5 public authorities, 3 card processing centers and 3 public entities.

Source: CBA

Over the year the number of plastic cards rose 428 thousand pieces and equaled 5 million pieces, which made on average 834.7 payment cards per thousand (mature) persons.

Internet banking is expanding. Thus, AZN 23.8 million worth 28.6 thousand of transactions were conducted through Internet-banking during the year. AZN 785.4 thousand worth 5.197 thousand of transactions were conducted through mobile-banking.

Charts and Tables

Charts

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