THE CENTRAL BANK OF
THE REPUBLIC OF AZERBAIJAN

№ 1(9)
2012

FINANCIAL STABILITY REVIEW

Q1

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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 pursued the financial stability policy in the environment of fragile growth in the global economy, slight slowdown in the sovereign debt problem in the eurozone, relative revival of global financial markets, expansion of lending and dwelling volatility in commodity markets in the first quarter of 2012. On the background of high prices for energy carriers in global commodity markets the foreign position of Azerbaijan was favorable which had a positive influence on ongoing growth dynamics of the country economy, including the non-oil sector.

In the environment of macroeconomic conjuncture the Central Bank targeted maintainance of financial sustainability of the banking system. The Bank was focused on liquidity of banks and credit risks during the reporting period and kept aligning the prudential supervision to the latest global challenges.

The conducted policy safeguarded financial stability, ongoing institutional development of the financial system with more access to financial services during the period. The capital adequacy and liquidity ratios of the banking system were maintained on an acceptable level. The findings of macro stress-tests also exhibit resilience of the banking system to the most severe macroeconomic shocks and the manageable level of credit risks.

I. OVERVIEW OF ENVIRONMENT

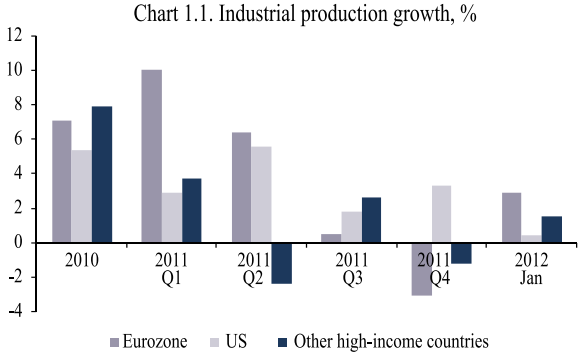
1.1. Recent global financial trends

The first months of the current year witnessed revival trends in the world economy. The USA and Germany - the largest economy of the euro area, were the prima drivers of the revival. However, the risks of slowdown in revival, fragile and weak economic growth are still high. Thus, recession risks in the euro area, weakening of economic prospects in DGCs pose risks for sustainability of the global growth.

Policies of separate countries and coordinated measures on the international scale resulted in ongoing global economic revival in the first quarter of the current year.

The improving situation in the labor market, recovery of stock exchange markets and credit channels in the **USA** – the locomotive of the global economy – catalyzed increase in consumer confidence and expenses. The consumer confidence index in the USA approximated to the pre-crisis level. Rise in consumer expenses reached its highs in the recent seven months. In February of the current year, the year over year growth of the industrial production in the USA was 4%, and the production capacity utilization ratio was 78,8% (76,5% in February, 2011).

Chart 1.1. Industrial production growth, %



Source: World Bank

Reviving economic activity was felt in the foreign trade turnover. The trade balance deficit of the USA has reached its highs since October, 2008. The unemployment level was over 8,3% during the first quarter.

The industrial production growth, though at a weaker rate, in the **Euro area**, that has a significant share in the world economy (18%), once more demonstrated probable smooth recession expectations here. The industry growth stemmed from rise in the energy sector that is mostly put down to seasonal factors. Production of non-durable goods went down. Growth in the Eurozone varies across countries. Thus, while production in Germany rose by 1,5%, it went down by 2,5% in Italy and 5,1% in Finland. Sluggish recovery of the economy negatively impacts the labor market as well. The level of unemployment peaked over the recent 14 years being over 10%. The highest unemployment level among the Eurozone countries goes to Spain (23,6%).

The measures by the European Central Bank on short- and long-term liqudity support, as well as maintaining of interest rates around a zero level to protect the economy from recession threats failed expectations. On the other hand, high oil prices elevate inflationary risks which restrict the potential of the ECB to accommodate the monetary policy.

Still high risks in DDCs, particularly in the Eurozone, brought about downturn of the economic activity in a number of **DGCs** (including China). The policy oriented at expansion of internal demand in most DGCs has a positive effect on mitigation of the global disbalance.

During the reporting period **financial markets** underwent revival. In the first quarter of the

current year the *MSCI World (Morgan Stanley Capital International World)* index reflecting the standing of the global stock exchange market grew by 11%, the *S&P 500*, covering the American stock exchange market 12%, and the *MSCI BRIC* (reflecting the stock exchange market of Brazil, Russia, India and) index by 13,5%. During the quarter the Dow Jones Industrial, DAX, FTSE 100 and Nikkey 225 indices respectively grew by 8,1%, 17,8%, 3,5%, 19,3%. In January – March of the previous year the change of these indicators made 6,4%, -1,8%, -1,0%, -4,6%. Over the quarter the positive dynamics in financial markets was conditioned by a number of factors: *(i)* even though temporary, solution of the sovereign debt problem in the Eurozone (Greece); *(ii)* expectations on the global economy recovery in the environment of strong macroeconomical statistics of the USA; *(iii)* probability of additional liquidity injections to markets by the Federal Reserve System and the ECB. However, the optimistic expectations of investors early in the year started to deteriorate, the reasons are: *(i)* the growth rate outloook for the Chinese economy was officially decreased to 7,5% from 8%; *(ii)* no necessity for the liquidity support of the Federal Reserve System due to inflationary expectations and gradual recovery of the US economy; *(iii)* still high risk of aggravation of the crisis in the Eurozone.

Whereas **commodity prices** in the world market rose in the first quarter of the current year, its growth rate was considerably lower

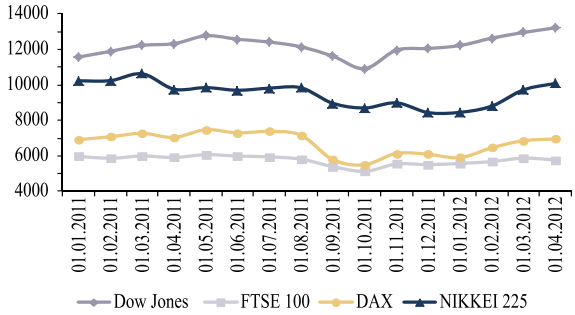
Box 1. Country ratings and sovereign debt rates

The IMF experts investigated the impact of ratings. The investigation studied the correlation between the country ratings of 72 countries in 2005 – 2012 and government debt rates. They analyzed data on 101,176 daily debt rates and only 194 rating changes by countries (26 downgrades, 57 upgrades, 71 positive and 40 negative outlook). The investigation released a number of interesting facts and results.

- Recent downgrade is the first in the last 79 years of the US history. The country has had the highest rating since 1941. The country rating remained stable up to the latest change;
- Downgraded rating requires a lot of years for recovery. It took Canada and Scandinavian countries 10 years to recover the country rating upon their downgrade early in 90s;
- There is no default for BB+ and over ratings. In 1975-2009 no defaults occurred in BB+ and over ratings. However, 14 defaults were recorded for below BB+ in the similar period;
- There is non-linear interaction between country ratings and borrowing rates. The higher rating is, the lower borrowing is. Downgrade of a country rating stipulates further expansion of borrowing rates spread compared to a highly rated country. In other words, the market embraces downgrade with a stronger multiplier impact;
- Dependancy between country ratings and borrowing rates over recent years has been diminishing. The estimations show that, if in 2005 this dependency was -0,34, it gradually declined duting the crisis and equaled -0,14 in 2010. Such a contraction in borrowing indicates more impact of other factors on borrowing rates.

Source: IMF WP 12/23, "Are rating agencies powerful?: An investigation into the impact and accuracy of sovereign ratings".

Chart 1.2. Global stock market indices

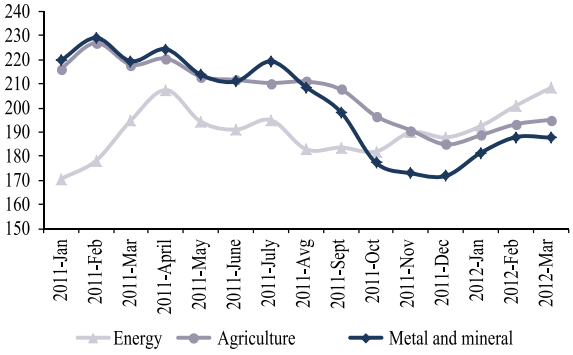


Source: Reuters

year over year. The factors affecting commodity prices are closely related to fluctuations in the global growth. This relation is reflected in synchronization of a commodity prices cycle with that of the global economic activity. In response to the probability of further decline in the global growth in 2011 and 2012, the commodity prices left the maximum level of recent 2-3 years behind.

Oil prices maintained a high level which is put down to the aggravated geopolitical situation.

Chart 1.3. Commodity prices index (2005 = 100)

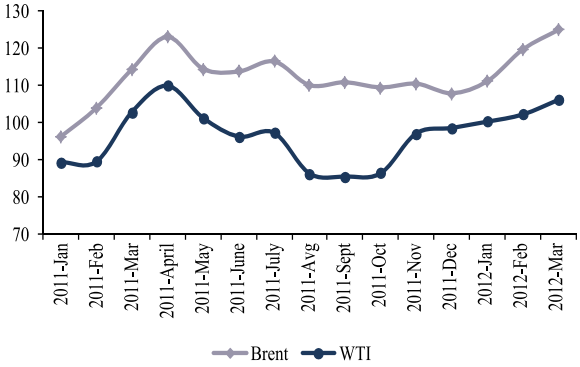


Source: World Bank

In 2012-2013 commodity prices are expected to remain unaltered in the environment of limited global recovery. In the event of higher-than-expected global growth, commodity prices may cyclically grow.

According to the latest **outlook** by the IMF, revival of the US economy and a favorable macroeconomic stance in DGCs in 2012 – 2013 will support acceleration of the real growth

Chart 1.4. Average monthly price for crude oil, $/ 1 barrel



Source: World Bank

rate of the world GDP. The IMF estimations suggest that, the economic growth rate in the USA will shift from 1,7% in 2011 to 2,1% in 2012 and 2,4% in 2013. The recent predictions on the Euroarea economy were upward revised compared to January. However, high oil prices, ongoing deleveraging in the European financial system, and the necessity for fiscal consolidation catalyze risks of sustainable economic revival. Japan is likely to grow by 2% after the tsunami and earthquake of 2011.

In total, according to the IMF outlook, the global economic growth will move from 4% in 2011 to 3,5% with further up to 4,1% in 2013.

According to the Global Financial Stability Report released by the IMF in April, 2012, the measures taken by countries to recover economy and the financial sector reaulted in relative stabilization of financial markets in Eurozone. Spreads on sovereign liabilities went down, and banks financing and prices for stocks were recovered.

Compared to the report released in September 2011, **the Global Financial Stability Map** underwent the following changes:

- The impact of *macroeconomic standing* on financial stability risks remained on an equal level. However, pressures to decrease leverage in European banks may result in decline in credit supply and downturn in economic activity.

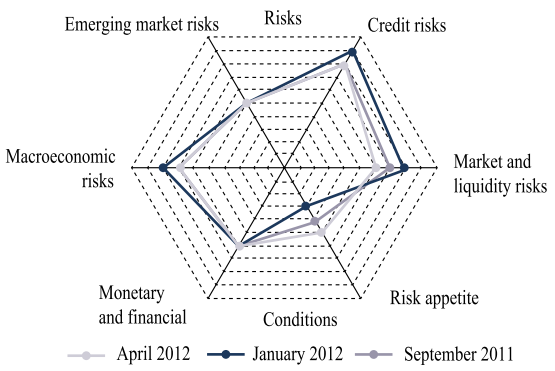
Table 1.1. The latest IMF outlook on the global economic growth, %

	2010	2011	Outlook	
			2012	**2013**
WORLD ECONOMY	**2.3**	**3.9**	**3.5**	**4.1**
DDCs	**3.2**	**1.6**	**1.4**	**2.0**
USA	3.0	1.7	2.1	2.4
Eurozone	1.9	1.4	-0.3	0.9
Germany	3.6	3.1	0.6	1.5
France	1.4	1.7	0.5	1.0
Italy	1.8	0.4	-1.9	-0.3
Spain	-0.1	0.7	-1.8	0.1
Japan	4.4	-0.7	2.0	1.7
United Kingdom	2.1	0.7	0.8	2.0
DGCs	**7.5**	**6.2**	**5.7**	**6.0**
CİS	4.8	4.9	4.2	4.1

Source: IMF

- *Monetary and financial condition* overall remained unaltered. Smoothing of the global monetary condition index was aided by hardening of bank lending requirements and deterioration of the financial condition.
- *Credit risks* are still high. In parallel, pressures on European banks are on the air. It is also necessary to strengthen capital reserves to increase demand for prolongation of debt liabilities and restore investors' confidence due to sovereign risks and sluggish economic growth rates in the Euro area.
- *Risks in emerging markets* were moderate and preserved the level. Overall, emerging markets possess an external shocks resistant buffer and policy framework. However, volatility of capital flows may have a considerable effect on lending and GDP growth.
- Three-year liquidity support for banks by the ECB contracted *market and liquidity risks*.
- Additional liquidity boosted "*risk appetite*". Bank shares recovered value and risks of default faded away.

Chart 1.5. Global financial stability map



Source: Global Financial Stability Report, IMF, April 2012

Note: Deviation from the center stands for increase in risks/vulnerability, smoothing of monetary and financial environment or rise in risk appetite.

European politicians elaborated the key elements of a comprehensive strategy to combat the crisis. The prima goal to maintain financial stability in the Euro area is to boost the quality of the existing crisis management mechanism, advance economic management in the Euro area and in every country, make efforts on a country level to consolidate the state budget, restore sound lending and improve growth plans.

Critical steps have been taken with respect to the Euro area crisis since September, 2011.

The national regulation program. The Euro area countries, that are facing tensions and fluctuations in financial markets, have undertaken fiscal regulation along with growth stimulation. To earn fiscal confidence the Euro area countries incorporated fiscal discipline to fiscal frames.

Agreement on assistance program for Greece. Terms and conditions to recover sustainable growth in Greece are clarified through segregating debt burden of the private sector and additional public support.

Expansion of the crisis management capacity. The permanent crisis management mechanism – the European Stability Mechanism was established in a relatively short time, its flexibility being improved.

Strengthening of bank capital. The European Banking Authority (EBA) has declared the necessity for application of an additional counter-cyclic buffer in concert with the Basel III requirements in banks in order to boost the level of capitalization of the banking system and increase the quality of capital. To that end, the EBA unambiguously recommends to meet

Box 2. Status of Basel III requirements implementation

Leading banks of the world are focused on consistent phased-in implementation of the Basel III requirements of the banking supervision from the standpoint of recovery of confidence in global financial markets, particularly the banking system, risk mitigation and maintainance of stability. Initially the focus is on revaluation of risk weighted assets. The Basel Committee released a report on implementation of the new requirements by member countries starting from October, 2011.

The status of implementation of the Basel III requirements (March 2012)

Country	Basel III	Next steps – implementation plans
European Union	2	Edition 3 of the compromise version published (28.03.12)
Argentine		Work on initial version of a new document in harmony with the new requirements is under way
Australia	2	Draft regulations on capital requirements published (30.03.12) New regulations for liquidity requirements released for public discussions (01.11.11-17.02.12)
Canada	2	The volume of Tier I Capital established at 7% f rom January, 2013 (01.02.11) Draft regulations on identification of capital and credit risks developed (mart 2012)
Japan	3	Draft guidelines on regulation published on February 7 and final version – March 30.
Saudi Arabia	3	Final guidelines on regulation published
Korea	1	Draft regulations to be published in the first half of 2012

Numerical codes: 1 = draft document not published; 2 = draft document published; 3 = final document published; 4 = final document took effect.

Source: Progress report on Basel III implementation, http://www.bis.org/publ/bcbs215.pdf

increased capital requirements through rise in the quality of capitalization and assets quality rather than through decrease in assets.

Improved governance. The EU countries adopted a "six pack" that simplifies governance and procedures. Most EU countries have entered into Fiscal Agreement that adds up to constructive rules reinforcing the commitments coming from the Stability and Growth Pact and oriented at avoiding fiscal mismatch. At the same time, procedures were adopted to coordinate, and monitor the fiscal policy, identify and correct mismatches.

The ECB support. The European Central Bank reduced the policy rate, the required reserve norm, and provided liquidity support for banks through the additional three-year refinancing program.

International organisations developed a number of recommendations for regulatory authorities of DDCs and DGCs to minimize financial stability risks in the upcoming period.

The developed countries need to conduct structural and institutional reforms to eliminate the crisis caused losses, and mitigate occurrence of the similar crisis in future. The most critical reforms should be directed at the financial sector. Because in some instances excess financing triggers shocks, deleveraging is still a necessary step for systemic stability. However, currently politicians are challenged to prevent leveraging so that it could not detsruct the banking system and promote adequate credit flow to the private sector. At the same time, politicians should readily provide liquidity for the banking system. Development of the prudential policy and framework should not be disregarded.

Relevant structures in **developing countries** should restrain the financial system from overactivity. DGCs, where the macroeconomic stance has been normalized, should be ready to protect themselves from undesirable external shocks and fluctuating capital flows. The fiscal policy in DGCs need to respond to diverse conditions and risks, with the necessity for establishing conditions for free performance of automated stabilizers. These countries also need to develop the prudential policy framework due to financial vulnerability.

1.2. State of the Azerbaijani economy

In the first quarter of 2012 the banking system operated in the environment of the strengthened foreign position of the country, high economic activity in the non-oil sector and maintained macroeconimic stability.

The foreign position of the country remained favorable in the environment of ongoing, however fragile growth in the global economy and high energy prices. In January – March, 2012 year over year export grew by 7% and import by 9% and the surplus of the foreign trade balance made USD 3,8 bln. To compare, the surplus exceeded that of 2011 by 7%.

In addition to export, remittances and foreign investments as well contributed to foreign exchange inflows during the year. According to the SSC, over the period the amount of foreign investments to the country economy rose by 19% and made USD 730 mln.

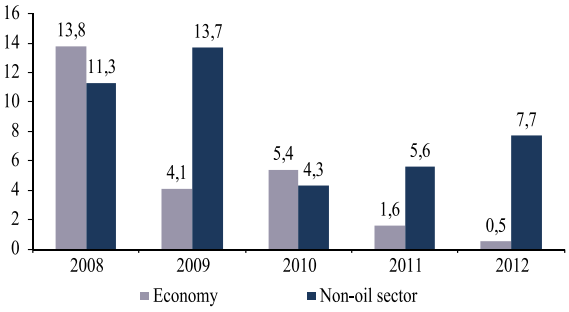
The strengthened foreign position of the country resulted in 7% increase in foreign exchange reserves of the country in January – March 2012, and exceeded USD 40 bln. – sufficient for a three-year commodities and services import.

The final consumption expenditures and investments – components of the aggregate demand – had a positive effect on the economic growth. Over the period, high growth rate of budget expenditures, including investment expenditures was the key factor to affect demand.

In parallel, nominal final consumption expenditures of the population increased by 14% and investments to the economy from all sources – 17%. 64% of investments were directed to the non-oil sector.

The economic growth of the country kept pace with the aggregate demand over the first three

Chart 1.6. Economic growth in January – March, %



Source: SSC

months of the year. In January – March, 2012 the real GDP grew by 0,5% and surpassed AZN 12 mln. in nominal terms. During the reporting period the non-oil sector grew by 7,7%. The two thirds of the value added goes to the share of production and the one third – services.

Single-digit inflation remained a critical objective in the environment of high prices in global commodity markets and revived aggregate demand. In March prices rose by 0,5% against the beginning of the year, and the average monthly inflation made 3,1%.

The Central Bank sterilized USD 233 mln. over the period to avoid considerable strengthening of the exhcange rate and neutralize negative impact on competitiveness of the non-oil sector. As a result manat strengthened against USD at a mdoerate rate – only 0,04%.

Decisions on monetary policy tools over the past period of the current year targeted price stability.

During the reporting period money supply was affected by seasonal factors and money base in manat grew by 0,9% while money supply increased by 2,4%.

II. DEVELOPMENT OF THE BANKING SYSTEM

2.1. Dynamics of the key indicators of the banking system

In the first quarter of 2012 the banking sector indicators continued to grow and develop institutionally.

As of the end of the first quarter of 2012 banking sector's assets made AZN 14685,9 mln. The banking sector assets grew by AZN 739,1 mln. or 5,3% (16,3% growth over the past one year) compared to the beginning of the year. In January – March of 2012 loans rose by 3% and made AZN 9993,4 mln. as of the end of the relevant period, which took 68% of bank assets.

Banks' deposit base (funds attracted from non-financial sector) gained 4,8%. Deposits of individuals grew by 4,3% and reached AZN 4298,9 mln.

Currently the Herfindahl – Hirschmann index[1] reflecting the concentration level of the banking system displays medium concentration in the system.

As of end-March, functioning banks were numbering 44. Compared to the relevant period of the previous year, 20 new bank branches (total 666) and 41 new bank departments (total 164) started functioning. The number of banks with foreign capital is increasing. The number of banks with foreign capital shifted from 22 to 23.

The number of NBCIs is also rising. The number of NBCIs shifted from 106 to 127 against the March of the previous year. The number of credit unions was 87, currently they are numbering 99.

During the quarter 63 branches of the AZERPOST LLC, that delivers financial services to the rural population, operated successfully. According to the data from April 1, 2012 year

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

	2009	2010	2011 / Q1	2011	2012 / Q1
Assets	13.6	13.9	2.4	7.3	5.3
Loans	17.3	9.0	-9.1	8.1	3.0
Deposits of legal entities	-18.8	4.3	-7.3	16.1	5.4
Deposits of the population	22.6	29.8	8.6	36.0	4.3
Aggregate capital	17.9	7.8	0.8	12.7	10.6

Source: CBA

Table 2.2. Dynamics of the Herfindahl-Hirschman index

	01.01.2011	01.04.2011	01.01.2012	01.04.2012
Loans	2085.1	1581.8	1430.0	1379.2
Term deposits of individuals	808.8	840.0	840.2	875.9
Aggregate capital	935.2	947.0	825.5	695.6

Source: CBA

[1] Herfindahl-Hirschman index equals to the sum of squares of banks' shares in the banking system. If the index value is below 1000 – concentration is low, 1000-1800 – medium and over 1800 – high.

over year increase in the number of departments of the AZERPOST LLC was 897 (624 in the previous year).

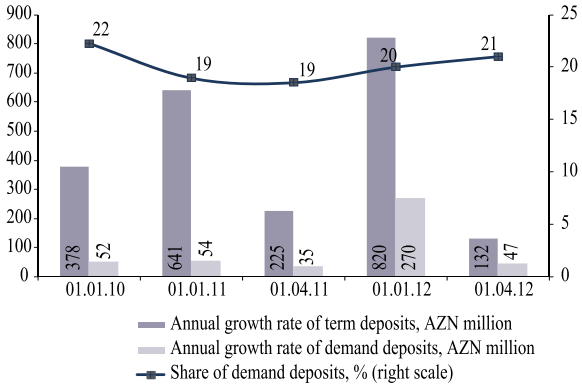
2.2. Liabilities of the banking system

In the first quarter of 2012 the banking sector continued to strengthen its resource base through more sustainable sources.

In January – March of 2012 banks liabilities increased by 5,9% (AZN 693,7 mln.) and made AZN 12 522,0 mln. as of 01.04.2012. Total deposits of banks grew by 3,7% (funds attracted from financial and non-financial sectors) and reached AZN 9796,5 mln. that takes 78,2% of total liabilities in the first quarter of 2012.

In the first quarter of 2012 the term structure of deposits witnessed positive trends. Term deposits grew by AZN 132,2 mln. while demand deposits - AZN 46,9 mln. The share of term deposits in total deposits made 79% as of the end of March.

Chart 2.2. Term of deposits of individuals



Source: CBA

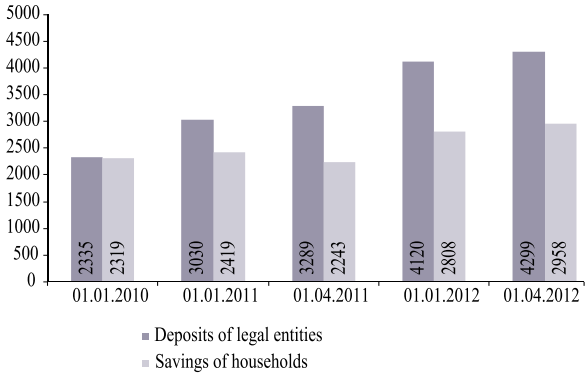
Table 2.3. Structure of bank liabilities, %

	01.01.2010	01.01.2011	01.04.2011	01.01.2012	01.04.2012
Deposits	39.7	41.9	46.8	46.8	47.7
Due to the CBA	6.4	4.8	6.3	4.9	6.5
Claims of banks	8.6	17.2	5.6	13.6	5.1
Other	24.5	18.6	22.1	17.7	22.0
Capital	20.8	17.5	19.2	17.0	18.6

Source: CBA

Deposits of the population grew by 4,3% during the reporting period and reached AZN 4298,9 mln. the share of which made 34,3% in bank liabilities as of the end of the period (year over year 31,6%).

Chart 2.1. Dynamics of deposits, AZN million

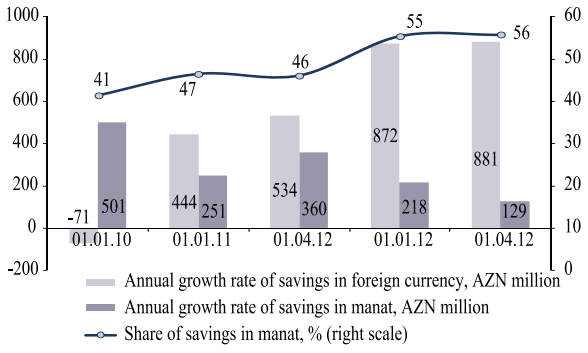


Source: CBA

High confidence of the population in the banking system resulted in increase in long-term deposits and deposits in the national currency. During the reporting period long-term deposits grew by 5,2% and approximated 36,2% (35,9% as of the beginning of the year) of total deposits.

Over the first quarter of 2012 deposits in the national currency rose by 5% and reached AZN 2395,7 mln. that takes 55,7% of deposits (year over year - 46,1%).

Chart 2.3. Currency structure of deposits of individuals

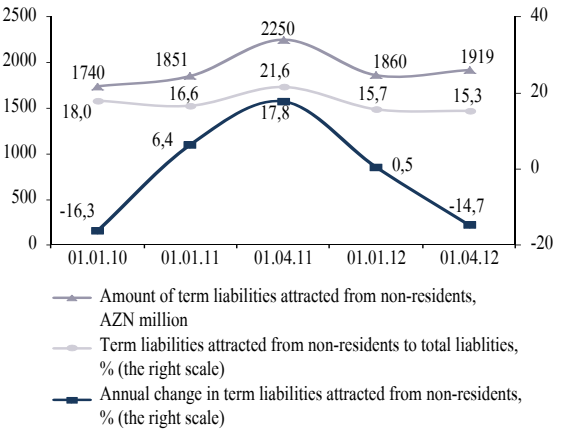


Source: CBA

Non-resident individuals are taking more interest in the Azerbaijani banking system. Thus, in January – March of 2012 the volume of deposits of non-resident individuals increased by 12,1% (year over year 2,6%) and took 9,7% of total deposits as of the end of the period.

Elevating economic activity promotes growth in deposits of legal entities as well 7,3% decrease in deposits of legal entities in the first quarter of the previous year was replaced by 5,4% increase over January – March. Thus, deposits attracted by non-financial institutions grew by AZN 150,3 mln. and made AZN 2957,9 mln. as of the end of the first quarter. The growth of the past one year was 31,9% and made 23,6% of bank liabilities (21,5% as of 01.04.2011).

Chart 2.4. Dynamics of term liabilities attracted from non-residents (excluding individuals)



Source: CBA

Deposits in the national currency prevail in those placed by legal entities with banks. In January – March of 2012 deposits in manat grew by 7.8%, while those in a foreign currency – 3.1%.

In January – March of the current year the funds attracted from non-resident banks and international financial institutions increased by 3.1% and levelled AZN 1918,6 mln.

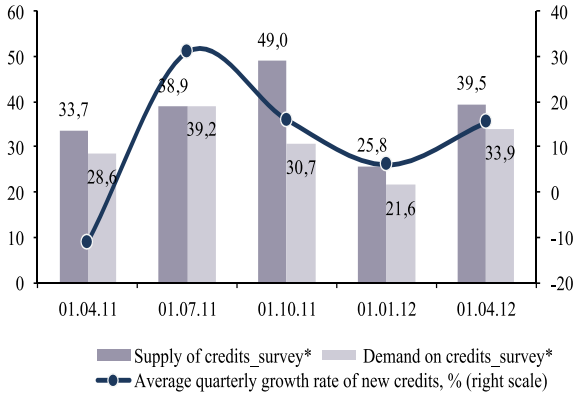
Foreign funds were on an acceptable level and took 15.3% of total liabilities.

2.3. Assets of the banking system

During the reporting period access to financial services continued to grow. Crediting is the key portion of active bank services.

Change in bank assets primarily (5.3% growth in the first quarter of the current year) sourced from credit investments and dynamics of securities. During the quarter credit investments rose by 3% and made AZN 9 993,4 mln. as of the end of the period.

Chart 2.5. Lending activity, survey fundings*



Source: CBA

As a result of favorable external environment and better financial standing of borrowers, long-term loans continued to grow (5.7% increase against January 1, 2012); their share in the structure of loans was 72.3% as of April 1,

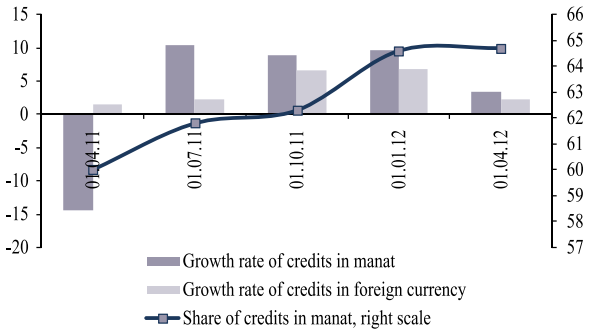
* The survey results were estimated via a "balance method": "Balance method" is the gap between the share of respondents who responded "increase" (easing) in total number of respondents and the share of those who answered "decrease" (tightening). The gap is called an index, that characterizes any manifestation on a component and is estimated as a basis point. The change rate of the index ranges between -100 and +100.

2012. Short-term loans decreased by 3.3% and made AZN 2769,6 mln. as of the end of the quarter.

The currency structure of the credit portfolio remained relatively stable over the quarter.

As in previous periods, the share of loans in the national currency in the total portfolio prevailed over those in foreign currency and made 64.9% as of end-quarter.

Chart 2.6. Currency structure of the credit portfolio , %



Source: CBA

Box 3. Lending in foreign currency

The currency structure of the credit portfolio has a direct impact on the level of the risk to be faced by the banking sector. Vulnerability of loans in foreign currency to exchange rate changes poses additional risks (direct and indirect). Thus, exchange rate changes may depreciate banks assets in foreign currency or increase credit risk of borrowers with no foreign currency income.

The European Systemic Risk Board is focused on increase in foreign currency loans of the non-financial sector. Since the loans of the type threaten financial stability, the Board elaborated 7 recommendations oriented at avoiding excess growth in foreign currency loans in October, 2011. The recommendations are meant for the EU countries, national supervisory authorities and the European Banking Authority.

Recommendation A: financial institutions are required to provide borrowers with adequate information on risks related to lending in foreign currency (the impact on installments of a severe depreciation of the legal tender, increase of the foreign interest rate etc.);

Recommendation B: the national supervisory authority should monitor levels of foreign currency lending and of non-financial sector currency mismatches. The loans of the type are recommended to borrowers that demonstrate high creditworthiness;

Recommendation C: the national supervisory authority should monitor whether foreign currency lending induce excessive credit growth and more actively apply relevant restrictions in such instances;

Recommendation D: the national supervisory authority may deliver relevant recommendations to banks regarding improvement of credit risks systems in foreign currency lending. These recommendations may vary depending on the volume and complexity of the banking activity;

Recommendation E: the national supervisory authority should recommend banks to hold adequate capital to cover risks and losses associated with foreign currency lending;

Recommendation F: the national supervisory authority is required to closely monitor financing and liquidity risks related to foreign currency lending. Maturity and currency mismatches between assets and liablities, currency transactions in foreign markets, and concentration of funding sources should be on particular focus.

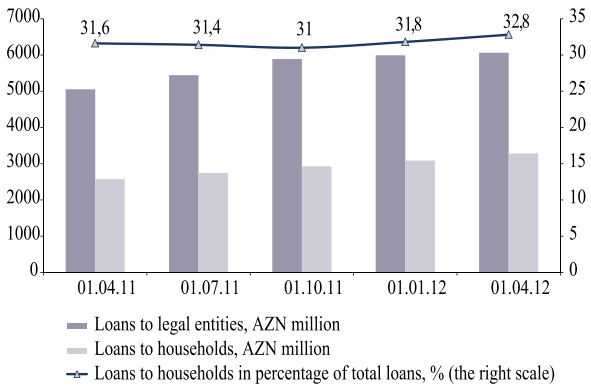
Recommendation G: as for international banking groups, requirements on foreign currency lending should be unified throughout the EU Member Countries. This recommendation is meant for foreign currency lending between a borrower and a bank domiciled in separate countries. Measures here should be individual, subconsolidated and consolidated.

Source: Recommendation of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies

Loans to legal entities granted by banks to legal entities increased by 1,1% and made AZN 6059 mln. (the share in portfolio 60,6%) as of the end of the period, while loans to individuals increased by 6,4% during the quarter and their share in the portfolio having increased by 1 percentage point compared to the beginning of the year made 32,8% as of April 1, 2012.

Over the quarter consumer loans (on all credit institutions) increased by 6,3% and took 74,8% of loans to households. Loans to individuals engaged in entrepreneurship grew by 3,2% and took 7,6% of loans to households.

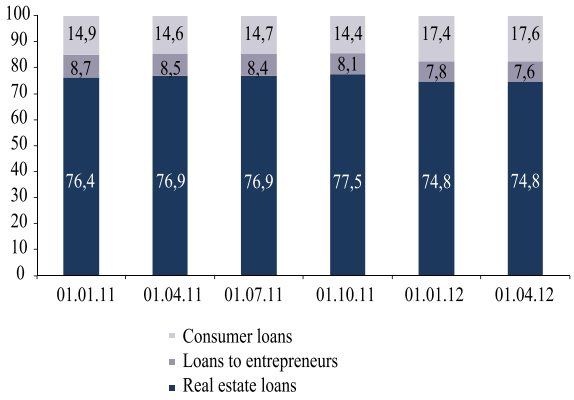
Chart 2.7. Dynamics of the credit portfolio structure by subjects



Source: CBA

Over the quarter loans to individuals for construction and purchase of real estate grew by 7,7% and made AZN 620 mln. as of April 1, 2012. The share of these loans in the portfolio of loans to households was 17,6% as of the end of the quarter.

Chart 2.8. Purpose structure of loans to individuals, %



Source: CBA

The share of long-term loans to individuals (on all credit institutions) grew by 8% and took 72,1% (AZN 2 541,8 mln.) of the portfolio over the quarter.

Loans to trade and services in the credit portfolio rose by 1,8% and took 29% of the credit portfolio as of April 1, 2012. At the same time, loans to agriculture and processing increased by 2,8%, transport and communications 4%, industry and production – 0,4%, and loans on plastic card operations 13,6 %.

Over the first quarter of 2012 credit institutions continued crediting of regions. Loans in the national currency in credit investments to regions prevailed over those in foreign currency

Table 2.4. Sectoral structure and dynamics of the credit portfolio of banks

Sector	01.04.12		Quarterly growth,%
	AZN million	Share in the credit portfolio, %	
Trade and services	2894.4	29.0	1,8
Households	3281.9	32.8	6,4
Agricultre and processing	469.9	4.7	2,8
Construction and property	858.7	8.6	-1,9
Industry and production	585.4	5.9	0,4
Transport and communications	426.0	4.3	4
Other	1656.4	16.3	2,9

Source: CBA

as in previous periods, and took 76,3% of the credit portfolio as of April 1, 2012. Long-term loans take the vast portion of loans in regions (66,1%).

In the first quarter of the current year profit of banks made AZN 38,6 mln. Net profit after taxes constituted AZN 35,9 mln. The number of banks operating with profit and loss over the period respectively was 36 (34 – as of 01.04.), and 8 (10 as of 01.04.2011).

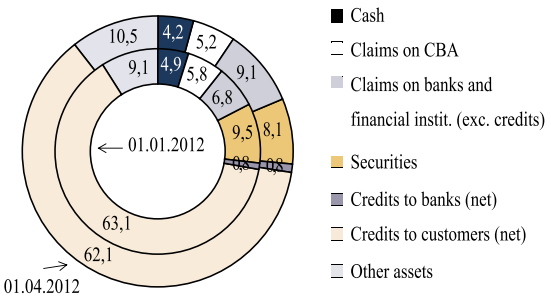
Table 2.5. Loans and deposits by regions (excluding Baku), AZN million

Date	Credit investments			Deposits		
	Total	in manat	in foreign currency	Total	in manat	in foreign currency
01.07.2010	1326,2	897,6	428,6	212,5	154,0	58,5
01.01.2011	1262,9	879,6	383,3	223,4	154,3	69,1
01.07.2011	1339,2	971,0	368,2	291,6	218,3	73,3
01.10.2011	1448,1	1055.6	392,5	311,8	224,8	87
01.01.2012	1271,7	940,1	331,5	327,6	242,7	85
01.04.2012	1273.4	972,1	301,3	386,9	270,2	116,7

Source: CBA

In the first quarter bank investments to securities increased by 4,2% and reached AZN 1413,8 mln. (AZN 1356,4 mln. as of January 1, 2012) as of April 1, 2012.

Chart 2.9. Structure of bank assets, %



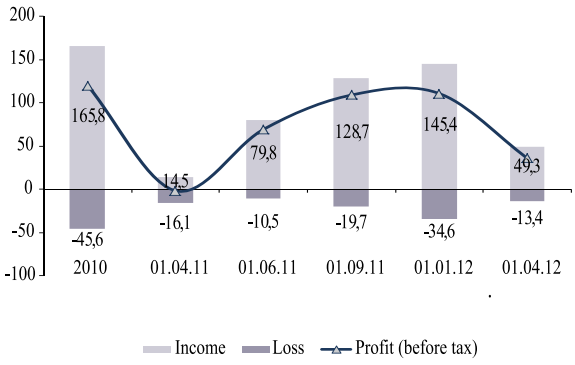
Source: CBA

As of April 1, 2012 the share of securities in assets made 9,6% (9,5% as of the beginning of the year).

2.4. Financial results of the banking sector performance

Over the period financial results of the banking system were positive and year over year profitability indicators improved.

Chart 2.10. Profit of the banking system, AZN million



Source: CBA

Owing to year over year rise in the share of loans in total assets, interest income on loans to customers increased by 17,2% (total AZN 279,5 mln. interest income). The year over year interest income to average assets ratio grew by 0,2 percentage point and made 7,9% as of the end of the period.

Year over year increase in income from other interest bearing operations (interbank exposures, investments and financial lease) was 15,9% and its ratio to average assets remaining stable made 0,6%. Total year over year interest

income increased by 17,1% (AZN 44,4 mln.) and reached AZN 303,6 mln. as of April 1, 2012.

Over the quarter total year over year increase in total non-interest income was 13,7% and constituted AZN 74,6 mln. as of the end of the reporting period. Rise in net income from foreign exchange operations, commissioning fees for other services and partially commissioning fee for maintainance of accounts contributed to this increase.

Overall total income (interest and non-interest) of banks constituted AZN 378,2 mln. and year over year increase was 16,4% (AZN 53,3 mln.).

Due to increase in the volume of long-term deposits of individuals, as of the end of the first quarter, year over year increase in interest expenses was 15,9% and made AZN 162,5 mln. Year over year rise in interest expenses to average assets ratio was 0,1 percentage point and made 4,6%.

Non-interest expenses rose by 12,5% against the relevant period of the previous year and constituted AZN 136,5 mln. as of April 1, 2012, the reason for which is rise in expenses associated with salaries in the banking sector, other types of compensation and fixed assets used in the banking system. Slight decrease to 3,8% from 3,9% in the share of total non-interest expenses in average assets was fuelled by reduction in other operating expenses.

Year over year rise in banks' total expenses (interest and non-interest) was 14,3% (or AZN 37,5 mln.) and equaled AZN 299 mln.

Box 4. Compensation policy in banks

As is known, compensation is defined as payments made by bank to bank administrators and employees in the form of salary and other type of reimbursement with respect to bank management and implementation of labor functions. The compensation policy in banks needs to be directed at avoiding perception of risk over the level addressed in a risk management strategy. In order to restrict procyclicality of the compensation policy and the risk appetite of bank administrators, the Basel Committee on Banking Supervision of the Bank for International Settlements elaborated the Compensation Principles and Standards Assessment Methodology.

Under the document in question, a compensation system is to be based upon the following principles as one of the key components of bank's corporate governance mechanism:

- the stumulus generated from the compensation system should add up to bank's competitiveness;
- the compensation system should be aligned to the bank's risk-based business activity;
- the compensation system should improve risk and IR management;
- the compensation system should target bank's long-term and sustainable growth.

The Bank should consider the following when developing the compensation policy:

- compliance of the risk perception framework of the compensation policy with the bank's risk management strategy;
- impact of the compensation policy on bank's capital adequacy;
- compliance of the compensation policy with bank's objectives and values, strategic targets, including long-term targets and the risk management system;
- the compensation system should not threaten bank's customers and shareholders.

Source: Compensation Principles and Standards Assessment Methodology, January 2010, Bank for International Settlements

Table 2.6. Profit structure, AZN million

	January - March 2011	January - March 2012	Change, %
Interest income	259.2	303.6	17.1
Interest expenses	140.2	162.5	15.9
Non-interest income	65.6	74.6	13.7
Non-interest expenses	121.3	136.5	12.5
Total income	324.9	378.2	53.3
Total expenses	261.5	299	14.3
Net operating profit	63.4	79.2	24.9
Loan loss provisioning	25.1	40.6	61.7

Source: CBA

In January – March of the current year banks' operating profit constituted AZN 79,2 mln. ROA was 1,0%, while ROE 8,3 %.

2.5. Banking sector capital

During the reporting period banking system continued to strengthen its capital base and the capital adequacy was maintained on an acceptable level.

In January – March of 2012 the volume of aggregate capital of the banking system increased by 10,6% or AZN 199,2 mln. and constituted AZN 2085,5 mln. as of the end of the quarter. The share of paid-in capital in aggregate capital was 85,3% (82,6% as of the beginning of the year). Over the quarter, the paid-in capital was the key source of aggregate capital. Thus, the paid-in capital grew by AZN 220,2 mln. or 14,1%. Total reserves rose 5,9% (AZN 9,5 mln.). Investments to shares of subsidiaries and other credit institutions and intangible assets constituted AZN 149,7 mln. (AZN 151,5 mln. year over year).

Capital adequacy on the banking sector was far above the threshold and made 15,4% as of the end of the reporting period.

Tier I Capital adequacy ratio in the first quarter of 2012 was far above the threshold (Tier I capital adequacy ratio – 6%) and shifted to 13,3% from 13,1%.

Table 2.7. Structure of bank capital, AZN million

	01.01.2012	01.04.2012
Paid-in capital	1558.9	1779.1
Share premium	20.7	20.7
Retained net gains (losses)	-40.7	40.7
Profit of the current year	163.5	49.3
Total reserves	159.5	169.0
Other funds of capital	151.5	149.7
Aggregate capital	1886.3	2085.5
Deductions from capital	-127.1	-123.2

Source: CBA

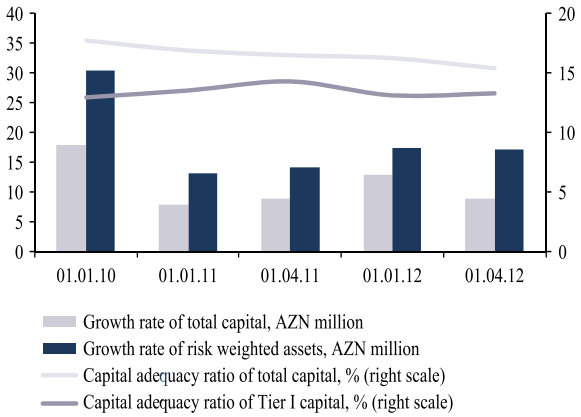
Box 5. Raising capital requirements and its macroeffects

The IMF experts investigated impact of raising capital adequacy – one of the Basel III requirements – on interest rates of banks loans and the GDP growth. The investigation revealed that, with the adequate response from the monetary policy the scale of impact will be not high. In total, the findings of simulation of 1% increase in the capital adequacy level throughout the world are as follows:

- it shall increase interest rates on bank loans by 0,159%, in DDCs - 0,151%, DGCs - 0,208%. The highest growth is expected to be in Brazil (0,253%), Korea (0,250%) and Japan (0,238%), while the lowest is expected to be in England (0,118%), USA (0,120%) and Canada (0,140%);
- in the event of no response from the monetary policy, the GDP will plunge into record lows within 4-8 years, reduction being 0,50%. In DDCs it will be the lowest – 0,46%, and in DGCs the highest – 0,74%. The highest rise will be in China – 0,83%, Brazil – 0,74% and Korea – 0,73%, and the lowest in the USA– 0,36%, England - 0,38% and Germany – 0,48%;
- in the event of response from the monetary policy, the reduction rate of the GDP wil decline by 4 times as much and make 0,13%, including 0,12% in DDCs, and 0.21% in DGCs. In this scenario, the highest decline goes to China– 0,24%, Brazil – 0,20% and Korea – 0,19%, and the lowest in the USA– 0,09%, England - 0,09% and France – 0,10%.

Source: IMF WP 12/44, "The global macroeconomic costs of raising bank capital adequacy requirements".

Chart 2.11. Capital indicators of the banking system



Source: CBA

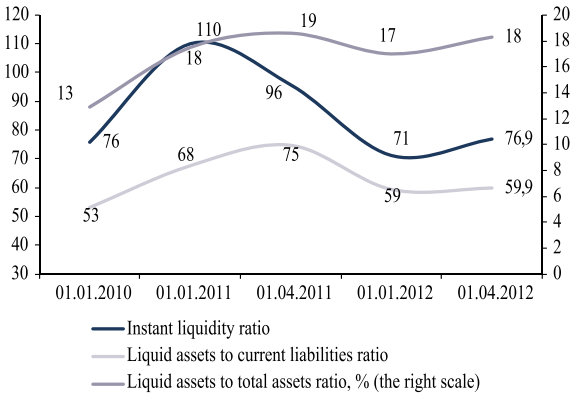
Ongoing application of the leverage ratio also contributed to capitalization of the banking system. The threshold on the leverage ratio is 8%. As of the end of March, 2012 the leverage ratio on the system was 10,7%.

III. RISKS IN THE BANKING SECTOR

During the reporting period liquidity in the banking system was high and credit and market risks were managed on a reasonable level.

Liquidity improved in January – March of the current year. The share of liquid assets in total assets increased to 18% from 17%, while the share of liquid assets in current liabilities moved to 60% from 59%. The instant liquidity ratio moved to 77% from 71% (threshold 30%).

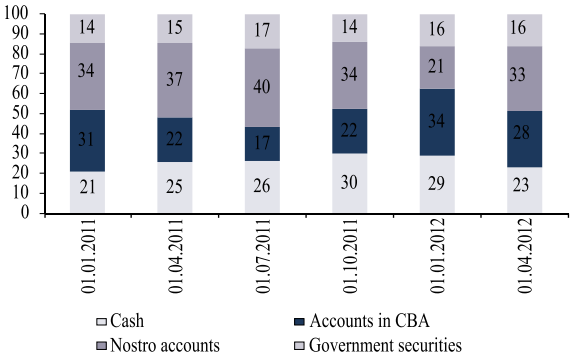
Chart 3.1. Dynamics of liquidity indicators, %



Source: CBA

As of April 1, 2012 the share of cash, nostro accounts and government securities in the structure of liquid assets respectively was 23%, 33% and 16%. The end of period share of banks' accounts with the Central Bank was 28%.

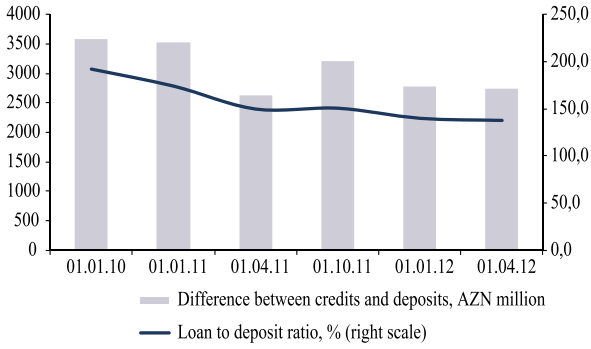
Chart 3.2. Structure of liquid assets, %



Source: CBA

During the first quarter of the current year the share of deposits of individuals and legal entities in credit financing increased. The loans to total deposits ratio declined to 138% from 140% (150% as of 01.04.2011).

Chart 3.3. Gap between loans and deposits



Source: CBA

Over the first quarter of 2012 the maturity gap on assets and liabilities maintained an acceptable level.

Chart 3.4. Gap between assets and liabilities to assets, %

Source: CBA

Box 6. Principles for Corporate Governance

The Basel Committee recommends the banks' effective corporate governance system to be based upon certain principles.

Principle 1. Bank's management has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, the risk strategy, corporate governance and corporate values.

Principle 2. Management Board members should be qualified and trained on an ongoing basis. They should have a clear understanding of their role in corporate governance and be able to exercise sound and objective judgment about the affairs of the bank.

Principle 3. The Management Board should have corporate governance expertise that should be permanently improved.

Principle 4. In a group structure, the board of the parent company has the overall responsibility for adequate corporate governance across the group and ensuring that there are governance policies and mechanisms appropriate to the structure, business and risks of the group and its entities.

Principle 5. Under the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board.

Principle 6. Banks should have an effective internal controls system and a risk management function with sufficient authority, stature, independence, resources and access to the board.

Principle 7. The sophistication of the bank's risk management and internal control infrastructures should keep pace with any changes to the bank's risk profile (including its growth), and to the external risk landscape.

Principle 8. Effective risk management requires robust internal communication within the bank about risk, through reporting to the board and shareholders.

Principle 9. The board and senior management should effectively utilise the work conducted by internal audit functions, external auditors and internal control functions.

Principle 10. The board should actively oversee the compensation system's design and operation, and monitor the compensation system to ensure that it operates as intended.

Principle 11. An employee's compensation should be effectively aligned with prudent risk taking: compensation should be adjusted for all types of risk; compensation outcomes should be symmetric with risk outcomes; compensation payout schedules should be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment.

Principle 12. The board and senior management should know and understand the bank's operational structure and the risks that it poses ("know-your-structure").

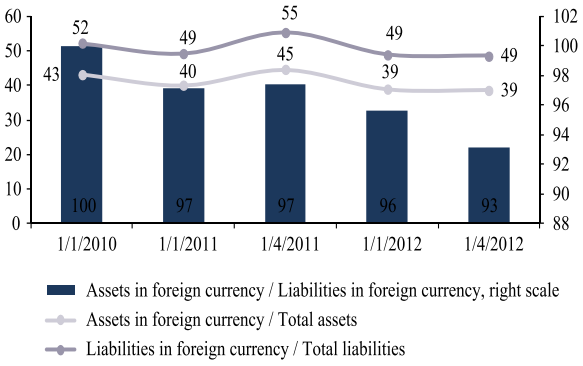
Principle 13. Where a bank operates through special-purpose or related structures or in jurisdictions that impede transparency or do not meet international banking standards, its board and senior management should understand the purpose, structure and unique risks of these operations. They should also seek to mitigate the risks identified ("understand-your-structure").

Principle 14. The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.

Source: Principles for enhancing corporate governance, October 2010, Bank for International Settlements

Currency structure of assets and liabilities was balanced to manage the effect of exchange rate risks. Over the past one year the share of assets in foreign currency in total assets declined to 39% from 45%. The share of liabilities in foreign currency in total liabilities shifted to 49% from 55%.

Chart 3.5. Foreign currency structure of assets and liabilities, %

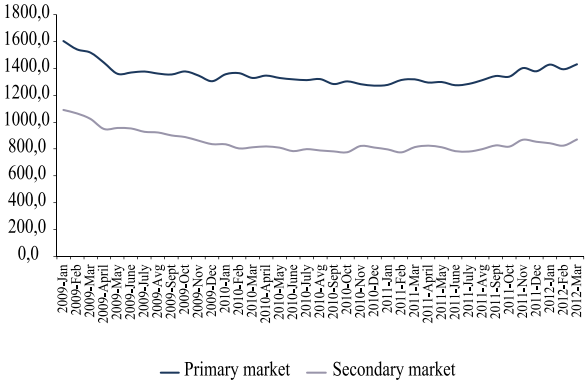


Source: CBA

Over the first quarter of 2012 the quality of the credit portfolio was on an acceptable level. The share of overdue loans in total laons made 6,5% as of the end period.

No processes occurred in the housing market to pose serious risks for the financial system during the reporting period. Compared to the beginning of the year prices in the primary market went down 3,8%, and in the secondary market – 2,0%.

Chart 3.6. Dynamics of prices in residential areas

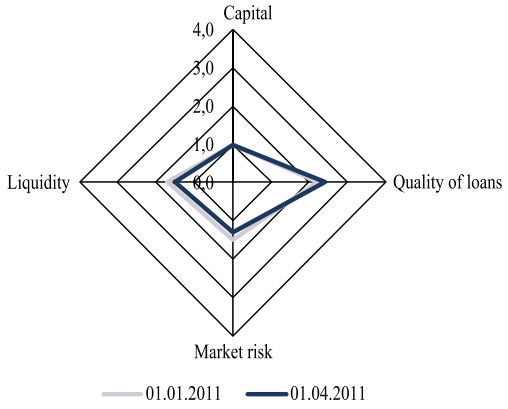


Source: MBA Consulting

The latest stress-tests demonstrate that the Azerbaijani banking system is resilient to extreme macroeconomic shocks.

According to the risk map of the Banking system, "1" stands for the most sustainable, while "4" – for the riskiest case.

Chart 3.7. Risk mapping of the banking system



Source: CBA

Capital adequacy maintains a sustainable level with parallel improvement in market and liquidity risks. Credit risks are well managed.

IV. PAYMENT SYSTEMS

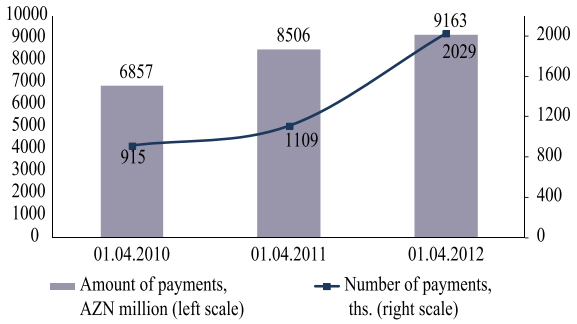
During the reporting period payment systems ensured stable and uninterrupted operations. The scale and number of transactions in the National Payment System adequately responded to the economic activity and institutional changes in the country.

Over the first quarter of 2012 AZN 25,.707 mln. worth 6,198 mln. transactions were made in the National Payment System. Year over year rise in the number of operations was 2,1 times as much (3273 thousand), and rise in total volume - 19% (AZN 4 109 mln.).

During the reporting period average daily number of operations was 93,9 thousand, while total volume equaled AZN 389,5 mln. (year over year respectively 44,3 thousand and AZN 327,2 mln.).

91,4% of cashless payments were made via the AZİPS, the total amount of which constituted AZN 23 506 mln. (88 thousand transactions). Year over year rise in total volume of transactions was 16,6% (AZN 3 339 mln.). The amount per payment order on average made AZN 272,1 thousand.

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



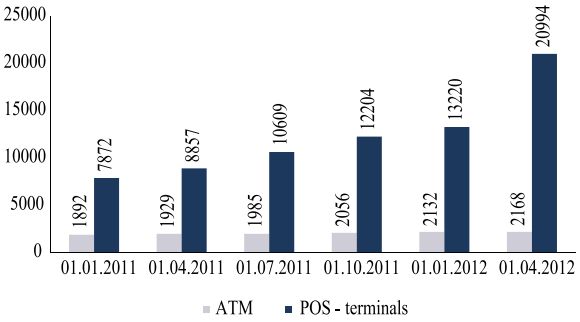
Source: CBA

8,6% (AZN 2,2 mln.) of transactions were made via the BCSS in terms of amount. The share of the BCSS in terms of number was 98,6%. During the reporting period 6,1 mln payments were made through this system, which exceeded year over year volume by 1,5 times (AZN 770 mln.) and number – by 2,1 times (3 257 thousand). Average amount per payment made AZN 360,8.

Commercial banks continued to expand plastic card infrastructrue. As of the end of the first quarter of 2012, 2 168 ATMs and 20 994 POS-terminals across the country served banks' plastic cards. To note, year over year rise in the number of POS-terminals was 2,3 times as much.

In the first quarter of 2012 AZN 1 758 mln. worth 11 725 mln. transactions were conducted through ATMs. The number of transactions through POS-terminals was 831 thousand, while their amount equaled AZN 108 mln.

Chart 4.2. Number of installed ATMs and POS-terminals



Source: CBA

Box 7. Role of the Central Bank in development of the payment system

Development of the payment system is directly related to the banking system growth. Opening of bank accounts, delivery of payment services to customers (real sector, public sector etc) through various tools are of the key functions of banks and other financial institutions. The Central Bank, being an active partner of the banking sector, simplifies and accelerates this process through its payment system policy. The Central Bank ensures safety and efficiency of the payment system as an operator, a catalyzer, an observer and a user.

A central bank may develop payment and credit service as an **Operator** or a payment system provider through the following measures:

- release cash as a direct payment tool and identify deposit exposures to ensure uninterrupted interbank payments;
- own, affect and participate at management of systemically important clearing and settlement system;
- conduct non-systemically important clearing payments and settlements;
- enable settlement system players to manage intra-day and end-of-day settlement accounts and place loans.

As a catalyzer a central bank may contribute to payment system reforms through the following measures:

- initiate, direct, investigate and consult on payment system's design, performance and policy;
- deliver consultations when developing the legislation proposed on the national payment system.

Oversight of the national payment system by a central bank may be ensured through the following:

- oversee existing and planned systems and assess their safety and efficiency;
- issue recommendations and ,if necessary, stimulate changes on design and transactions of the payment system;
- publish oversight principles, policies and regulations.

As a payment service user a central bank may be involved in clearing and settlement systems:

- using the system, make and accept payments on its own behalf and on behalf of customers (public authorities and agencies);
- employ settlements on securities and depositary for its activities;
- launch relations with other central banks and finacial institutions employing correspondent banking.

Source: General guidance for national payment system development, January 2006, Bank for International Settlements

The number of plastic cards grew by 80 thousand over the quarter and reached 4,7 mln. which makes on average 776,7 payment cards per thousand persons (mature).

İnternet-banking is expanding. Thus, AZN 1,3 mln. worth 6,6 thousand transactions were conducted through Internet-banking.

Charts and Tables used

Charts

Tables

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