

2010

Financial Stability Review
January – September 2010

**Central Bank of the Republic of
Azerbaijan**



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Brief summary

During the past period of 2010 key indicators of the banking sector, including deposit base and credit portfolio kept growing. While a slight hardening was observed in respect to revival in the banking sector during the year, liquidity reserve being rather high and capital adequacy indicators of banks exceeding minimum norms set by the Central Bank proved sustainability of the banking sector.

In the environment of boost for loan demand banks are targeted at increase of control over credit portfolio. To that end stress-testing is actively utilised along with traditional means. Despite certain changes in the quality of the portfolio, share of non-performing loans lags much behind the critical level. However, level of loan loss provisioning by banks exceeded the volume of substandard loans by 2 times.

Deposits of the population kept growing, growth rate of deposits in manat prevailed over growth rate of deposits in foreign currency.

The past period once more confirmed resistance of the banking sector to external shocks and capability to timely and fully implement internal and external liabilities. Simulation analysis of vulnerability of banks to the most exceptional but possible shocks displays that, banks possess sufficient capital buffer to absorb potential losses.

Built on gained expertise and international best practice, the Central Bank will endure its performance aimed at protection of stability of the banking sector and payment systems in the following periods.

Detailed information on results of the performance of the banking sector of Azerbaijan has been provided in *Financial Stability Review*.

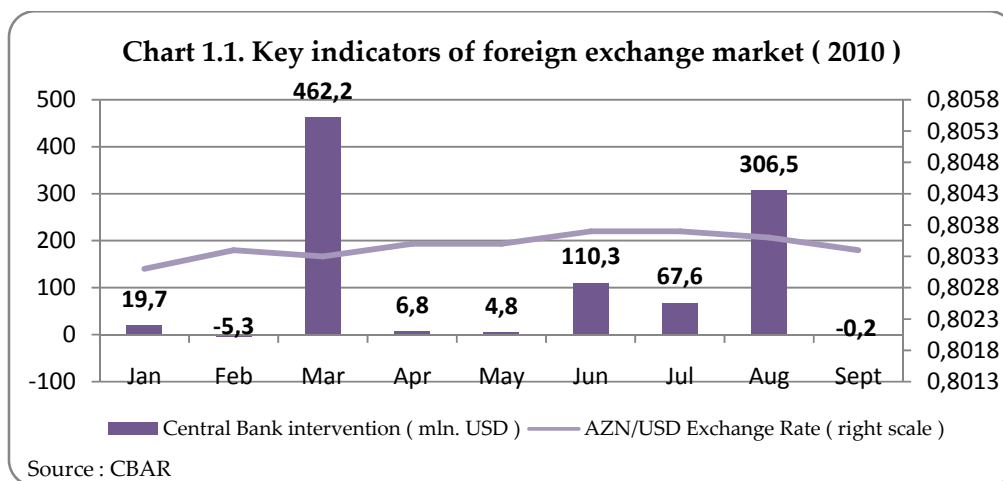
I. Financial markets

1.1. Foreign exchange market

Total volume of internal foreign exchange market made AZN18 333,4 mln having decreased by 3,3% against January – September of the previous year.

Volume of transactions in unorganized foreign exchange market (OpIFEM and IBT) rose to AZN18 014,4 mln having increased by 2,2% (or AZN391,6 mln) against the similar period of the previous year and took 98,3% of internal foreign exchange market. Volume of transactions conducted in IBT constituted 57,8% of unorganised foreign exchange market.

Volume of organised interbank foreign exchange market (BEST) has decreased to 76,1% (or AZN1018,1 mln.) made AZN318,9 mln. and took 1,7% of total volume of internal foreign exchange market.



Volume of net purchase of the Central Bank in January – September, 2010 made USD972,4 mln. The highest volume of currency intervention was observed in March and August. During Quarter 3 of 2010 average monthly official exchange rate of manat against the USD fluctuated within the range of 0,8031 – 0,8037 (Chart 1.1).

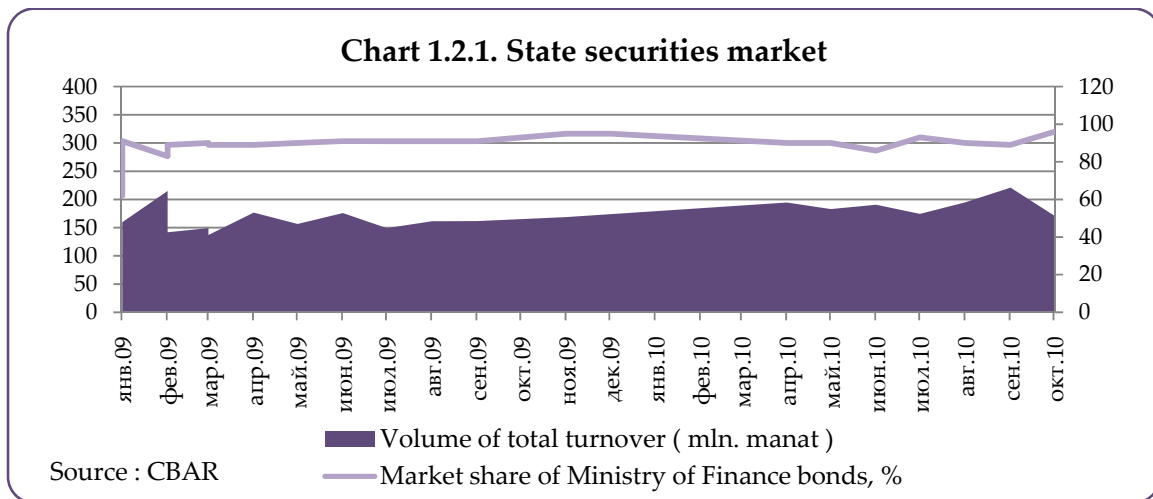
1.2. Stock exchange

1.2.1 State securities market

During the reported period the Ministry of Finance continued transactions on placement of State Short- and Medium-term Bills.

The volume of placed bills constituted AZN173,9 mln. Of this 78,4% was implemented in second and third quarters– respectively AZN74,3 and AZN62 mln. Volume of ST-bills in circulation has increased by 34,8% (or AZN50,9 mln) made AZN196,9 mln during the period. Return on ST- and MT-bills and annual coupon rates ranged between 0,7% - 4,5% within 9 months of 2010.

The Central Bank has placed notes amounting to AZN159,6 mln within 9 months. To compare, volume of placement in the relevant period of the previous year made AZN237,9 mln. Return on notes preserved 1% level. Volume of notes in circulation shifted from AZN10 mln. to AZN 24 mln.



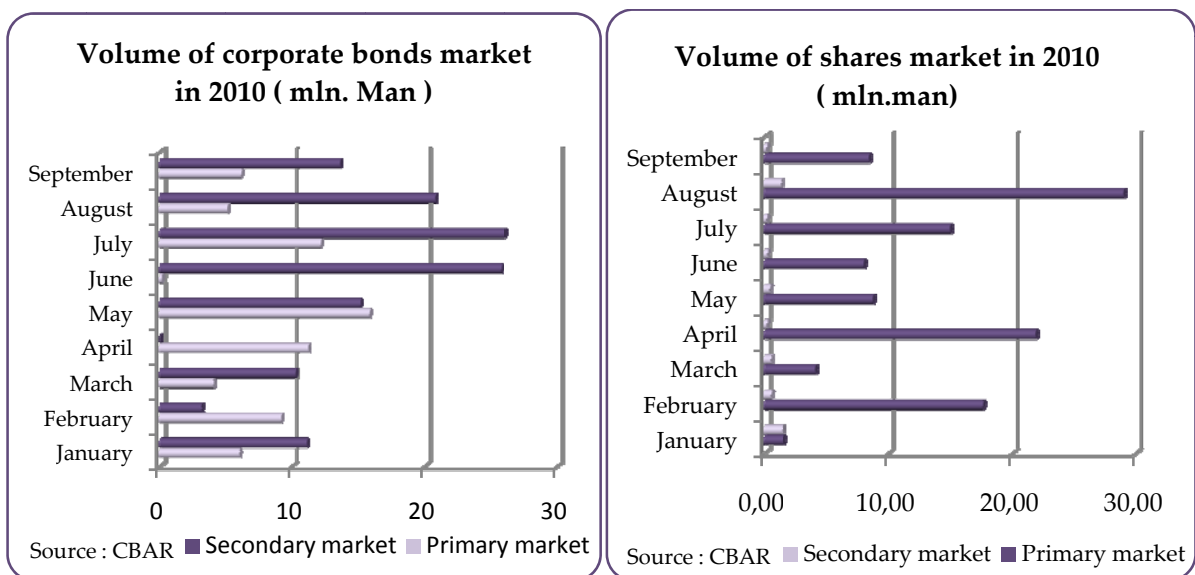
1.2.2. Corporate bonds and shares

Growth in corporate securities market within 9 months of 2009 constituted AZN314,8 mln having increased by 23% against the similar period of the previous year. The growth was observed both in transactions in primary and secondary markets (respectively 5% and 66%).

While the volume of corporate bonds placed totaled to AZN36,2 mln during Quarter 3 of 2009, in 2010 this indicator equalled to AZN69,7 mln having increased by 93%. Volume of the secondary market rose to AZN 125,7 mln having increased by 2,9 times as much. Turnover of notes placed by the Azerbaijan Mortgage Fund was the key factor to trigger growth of corporate bond market.

During the period volume of placed shares has decreased by 32% declined to AZN119,3 mln against January – September, 2009.

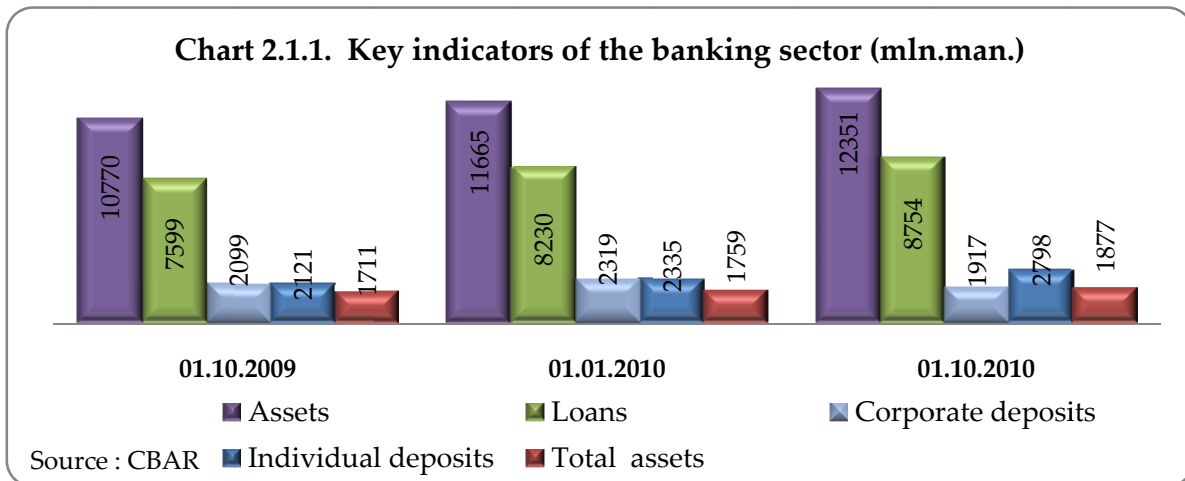
Chart 1.2.2. Volume of the corporate bonds and stock market



II. Banking sector and risks

2.1. Dynamics of the banking sector

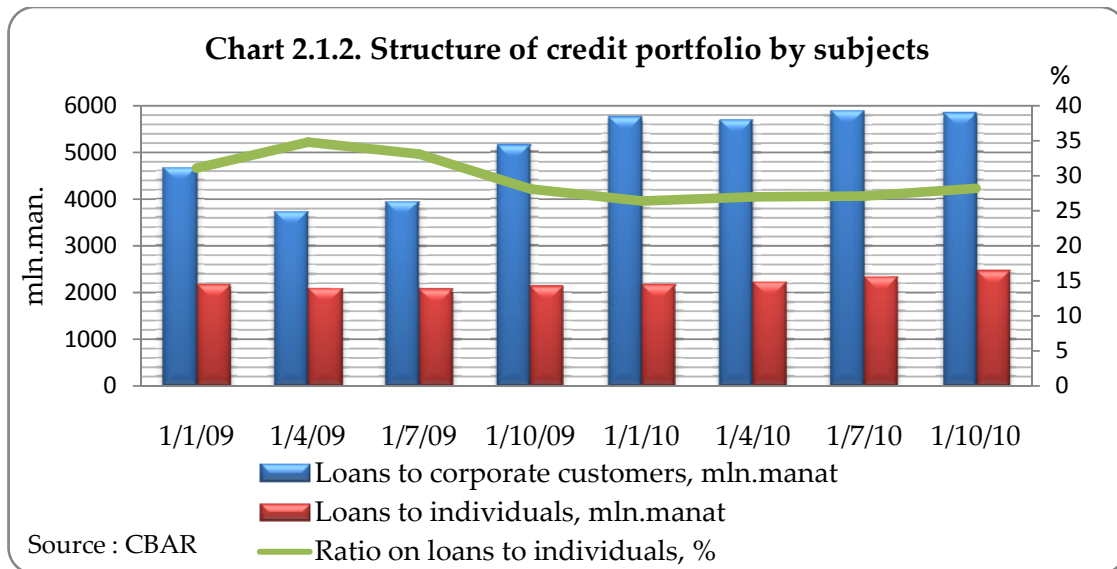
During January – September of 2010 assets of the banking sector having increased by AZN685,3 mln or 5,9% rose to AZN12,4 bln as at 1 October 2010. As of current September assets increased by AZN1,6 bln (14,7%) against the relevant month of the previous year. 44% of annual growth of assets falls into the share of the current year (Chart 2.1.1).



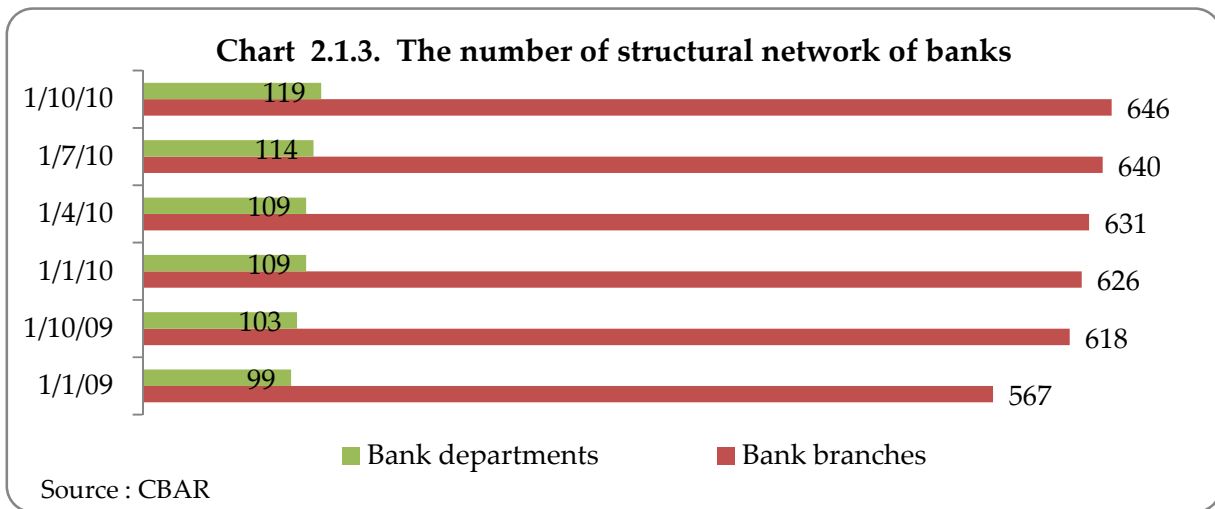
Assets growth is primarily due to growth of credit portfolio (66%). Against the beginning of the year bank loans have increased by AZN 523,8 mln or 6,4% rose to AZN8754,2 mln as of 1 October 2010. Loans increased by AZN1,2 bln (15,2%) against the relevant date of the previous year. 45% of annual growth of credit portfolio falls into the share of current year. Credit portfolio primarily grew due to term deposits of individuals, interbank operations and funds attracted from other financial institutions.

Within 9 months of the current year volume of loans to legal entities increased by 1,4% (annual 13,3%) and made AZN5,8 bln. Volume of loans

to households has increased by 13,6% (annual 15,6%) since the beginning of the year and constituted AZN2,5 bln. At the same time share of loans to individuals took 26 – 28% of total loans of banks in the current year , (Chart 2.1.2).



In order to provide demand of the economy for financial services, increase in access to financial services banks kept expanding their branch network and other structural units. Banks launched 21 new branches within 9 months, thus the number of bank branches totalled to 646, with 10 new bank departments opened the number of bank departments became 119 (Chart 2.1.3).



Thus, if to compare with the year launch, access to financial services increased. Each 1000 sq.m. of the country territory is served by 8,8 (8,1 at the yearlaunch) bank branches and departments, 11,2 (10,3 at the yearlaunch) bank branches and departments serve 100.000 mature population.

2.2. Financial sustainability of the banking sector

Capital adequacy indicators of the banking sector were at an acceptable level, share of Tier I Capital in total capital equaled to 81%. In order to enhance counter-cyclic supervision additional capitalization ratio – leverage ratio was applied.

Volume of the total capital of the banking sector having increased by 6,7% constitutes AZN1,9 bln within 9 months of the current year (annual growth being 9,7%). Key portion of capital growth was witnessed in Quarter III.

Capital sustainability was primarily provided through funds of shareholders. Thus, authorised capital rose by 17,2% (AZN199,2 mln.) against the yearlaunch and made AZN274 mln (25,1%) (Table 2.2.1).

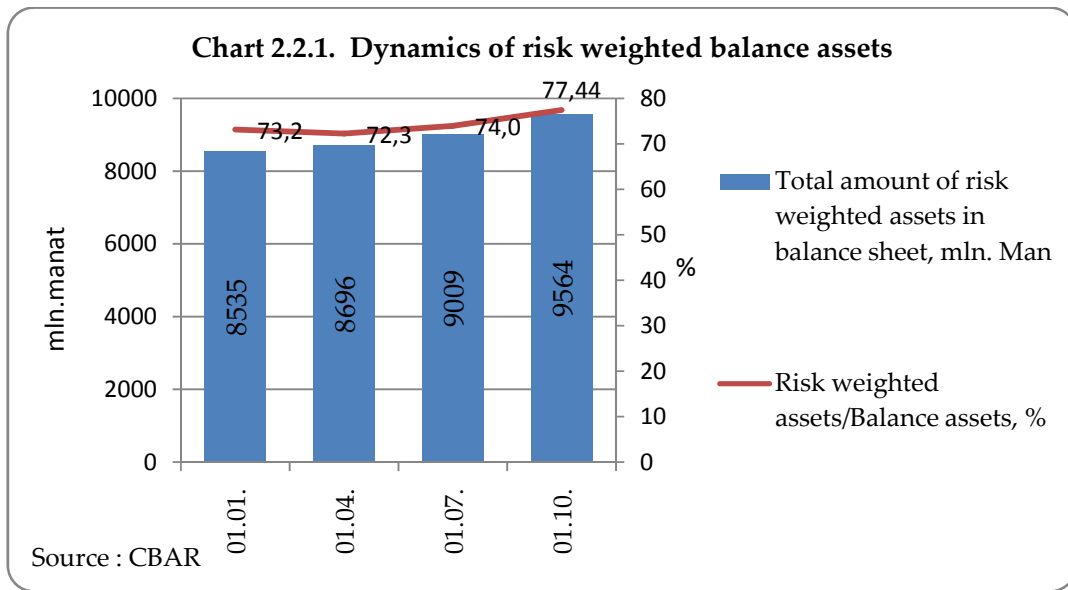
**Table 2.2.1. Structure and dynamics of the total capital of the banking sector
(mln.man.)**

	1/10/2009	1/1/2010	1/10/2010
Tier I Capital	1286.5	1 285.5	1520.0
Authorized capital	1057.9	1144.6	1343.5
Share premium	32.3	20.7	20.7
Retained net earnings	214.0	138.8	182.3
Tier II Capital	472.9	530.9	415.4
Profit of the current year	219.0	269.6	134.8
Aggregate reserves	109.5	122.8	137.5
Other funds of capital	144.3	138.6	143.2
Deductions from total capital	47.6	57.0	58.3
Total capital after deductions	1711.2	1 758.9	1876.5

Source: CBAR

At the same time, participation of foreign investors in capital of the banking sector increased as well. Within 9 months of the current year capital investments of shareholders of the type to authorized capital of banks increased by 18,5 % (AZN37,8 mln) and constituted AZN 242,3 mln as of 01.10.2010 (17,8% of total authorised capital of the banking sector).

Increase of credit activity due to revival of economic activity stipulated growth of share of risk weighted assets (Chart 2.2.1).



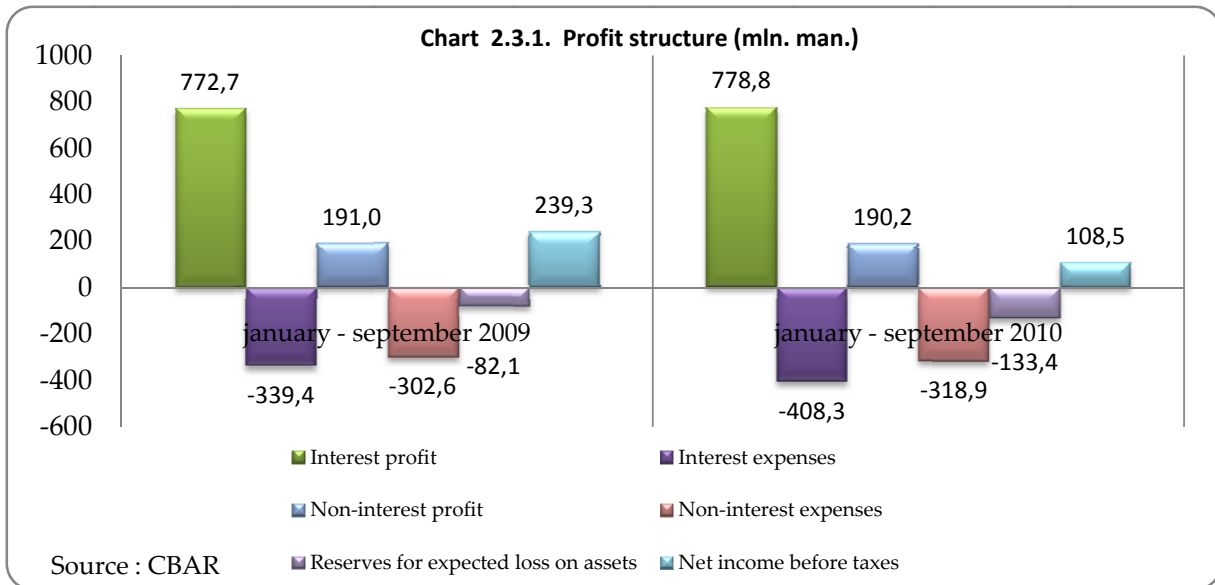
Actual level of systemic capital adequacy indicator displays significant capital reserve buffer in banks. Total capital adequacy of the banking sector preserved its high level (17%) and markedly prevailed over the minimum norm set by the Central Bank (12%). At the same time, adequacy of Tier I Capital increased against the year launch (13%) and made 13,7% that double exceeds the norm.

In order to neutralize disbalances in growth rate of assets and capital, provide their sound growth the Central Bank applied new Leverage ratio¹ from September of the current year.

2.3. Financial results of performance of the banking sector

Stability of banks financial standing endured.

Profit (before tax) generated by banks within 9 months of 2010 constituted AZN108,5 mln (Chart 2.3.1). Net profit after tax made AZN 94,7 mln.



Despite gradual decrease in interest rates on loans, decrease of consumer shares with higher interest rate in portfolio, increase in volume of credit investments resulted in 0,8% increase in banks interest income against the relevant period of the previous year and made AZN778,8 mln.

Total income from other interest income generating operations (interbank exposures and investments) increased by 11,8% and made 0,9% against assets (1% within 9 months of the previous year).

Non-interest income of banks did not alter against the relevant period of the previous year and constituted AZN190,2 mln. Total income of banks made AZN969 mln and did not change against relevant period of the previous year in absolute expression. But due to increase in volume of assets during the period income (interest and non-interest) shifted from 13,1% to 10,8% against average assets.

Interest expenses increased by 20,4% in comparison with 9 months of the previous year and made AZN408,3 mln as of 01.10.2010. This is primarily due to increase in volume of funds attracted from individuals. Despite increase in interest expenses in absolute expression, their ratio to average assets did not change against the relevant period of the previous year and made 4,6%.

If to compare with January – September of the previous year, despite a slight increase of the volume of non-interest income in absolute expression their ratio to average assets of the banking sector shifted from 4,1% to 3,6%. Relative decrease of non-interest expenses is sourced from effective changes in the structure of operational expenses of banks (not related to interest).

During the period volume of net income from operations of banks in foreign currency decreased by 13,2% against the relevant period of the previous year and constituted AZN60,1 mln. Specific weight of income generated from operations in foreign currency in total income equaled to 6,2%, its ratio to average assets of the banking sector shifted from 0,9% to 0,7%.

Potential risks in lending policy of banks were maximum considered. This trend displayed itself in dynamics of volume of deductions to cover reserves for possible losses on assets. Thus, deductions of the type

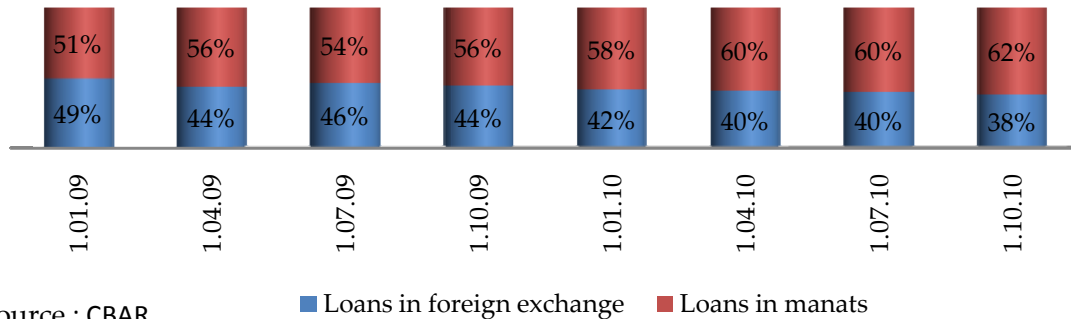
increased by 62,5% against relevant period of the previous years and made AZN133,4 mln.

In the end, ratio of net profit to assets (ROA) was 1,1% within 9 months of 2010, net profit to capital (ROE) equalled to 7,8%.

2.4. Credit portfolio

Lending activity kept growing in Quarter II of the current year. In order to protect quality of the credit portfolio methods and means used by banks kept their importance. At the same time, in-depth assessment of borrower's creditability, stress-testings enjoy particular importance.

Exchange rate protecting stability triggered 13,7% growth of loans in national currency in January – September and became the reason for its being primary source of total credit portfolio growth which resulted not only in prevention of potential dollarisation in lending structure, but also in shift of specific weight of loans in national currency from 58,5% to 62,5% (Chart 2.4.1). Share of currency composure in liabilities of the banking sector successively decreasing creates favorable condition to mitigate dollarisation of overall credit portfolio of banks and risks (direct and indirect) arising from exchange rate volatility.

Chart 2.4.1. Currency structure of credit portfolio


Growth rate of long-term loans (6,8%) almost keeps pace with growth rate of total loans (6,4%). Specific weight of long-term loans in the structure of credit portfolio made 73-74%.

There have been changes in sectoral structure of loans along with currency structure. The highest growth rate on loans (against the similar period of the previous year) was observed in non-oil industry and production, trade and services, agriculture and processing, construction and property. During the reporting period volume of loans to energy, chemistry and natural resources, transport and communication decreased (Table 2.4.1).

Table 2.4.1. Sectoral structure of credit portfolio

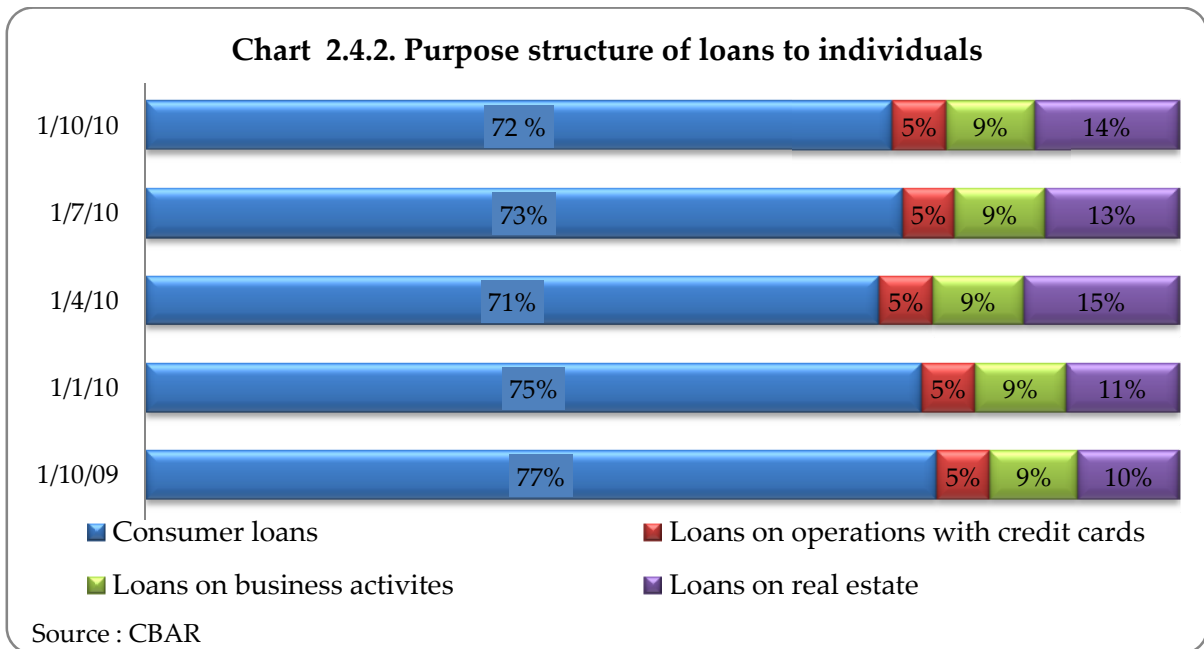
	10/1/2009		10/1/2010		Increase, decrease		Including January – September 2010	
	mln. man.	share, in %	mln. man.	share, in %	mln. man.	share, in %	mln. man.	share, in %
Trade and services	1645.4	21.7	2078.0	23.7	432.6	26.3	244.5	13.3
Households	2135.3	28.1	2467.7	28.2	332.4	15.6	296.1	13.6
including	117.1	1.5	137.7	1.6	20.6	17.6	18.3	15.3

<i>Loans on operations through plastic cards</i>								
Energy, chemistry and natural resources	1353.6	17.8	1061.8	12.1	-291.8	-21.6	-460.2	-30.2
Agriculture and processing	361.7	4.8	429.3	4.9	67.6	18.7	40.0	10.3
Construction and property	443.2	5.8	623.6	7.1	180.4	40.7	47.2	8.2
Industry and production	544.2	7.2	659.9	7.5	115.7	21.3	123.2	23.0
Transport and communication	475.6	6.3	463.0	5.3	-12.6	-2.6	-57.4	-11.0

Source: CBAR

Lending of the population still takes significant place in banking services. Starting with Quarter II banks have been actively growing retail lending.

Growth of volume of loans to individuals was due to mortgage and consumer lending. As at 1 October 2010 of household loans, specific weight of loans extended for consumer purposes was 72%, and mortgage loans totaled to 14%. Against the year launch and relevant period of the previous year share of consumer loans in structure of household loans decreased, share of real estate loans increased, share of entrepreneurial loans and outstanding balance on credit cards remained unaltered (Chart 2.4.2).

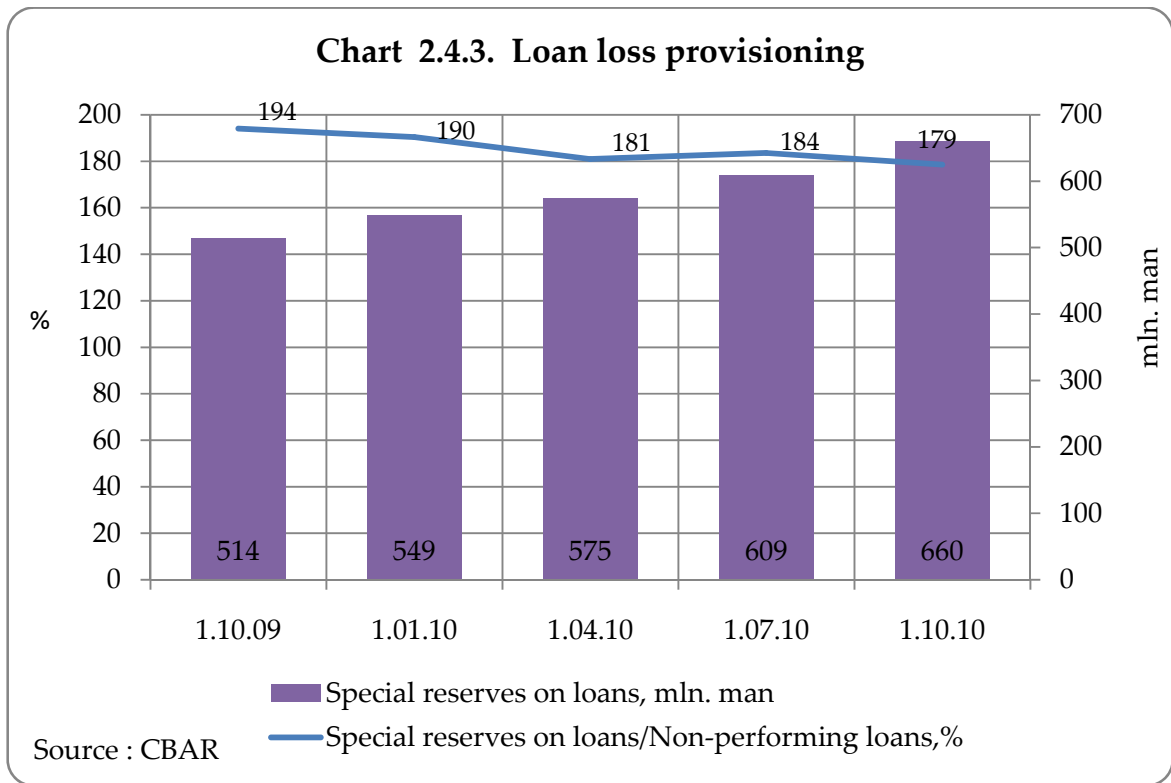


Growth of the volume of mortgage loans stipulated growth of long-term loans in consumer portfolio of banks. Specific weight of these loans in the current year shifted from 68,2% to 69,7% against the previous year.

Borrowings on mortgage loans increased by 27,6% within 9 months of the current year and as of 01.10.2010 constituted AZN1161,6 mln. Specific weight of these loans in total loan portfolio makes 13,3%.

Quality of credit portfolio remained at an acceptable level. Thus, non-standard loans took 7,4% (6% as at 01.01.2010) of the portfolio. Share of non-performing loans in the portfolio was 4,2% (3,5% at the yearlaunch).

As of 1 October 2010 loan loss provisioning constitutes 7,5% (6,7% as at 01.01.2010) of the portfolio. As before, as at 1 October 2010 loan loss provisioning created by banks 2 times as much exceeded non-performing loans (Chart 2.4.3).



2.5. Financial resources and liquidity risk

During January – September of 2010 primary source of resource base for banks was deposits attracted from legal entities and individuals. Liquidity level of bank assets is sufficient to timely meet commitments before creditors and borrowers.

As in previous periods deposits and savings attracted from legal entities and individuals were priority source of financial resources. If to compare with the year launch total deposit base of banks has increased by AZN 61 mln. and constituted AZN4,7 bln. During the period, share of deposits and savings in the structure of total liabilities was 46-48%, and in total resource base 38-40%.

In January – September of the current year seasonal volatility was witnessed in dynamics of legal persons. As of the end of September volume

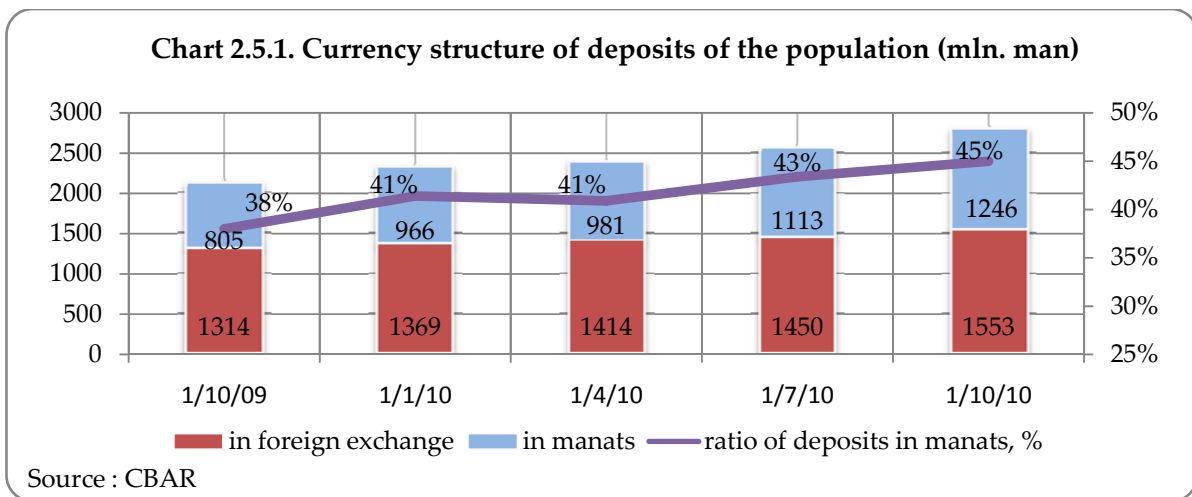
of deposits of legal entities decreased by 17,4% and made AZN1,9 bln. On an annual basis deposits increased by 8,7% and made 18,8% of total bank liabilities.

During January – September deposits of the population increased by 19,8% and equaled to AZN2,8 bln. On an annual basis deposits increased by 32%. Significant growth of deposits was observed in Quarters II and III of the current year. Share of deposits of the population in attracted resources is observed to grow that reflects the policy of banks to diversify financial resources. Thus, banks mainly prefer internal resources to increase financial flexibility and mitigate liquidity risk. As of 1 October 2010 share of deposits of the population in bank liabilities was 27,4% (including term deposits – 22,3%) (as of January 1st 2010 -respectively 24,2% and 18,8%).

Deposit base absolutely increasing its quality changed for the positive as well. Thus, growth of term deposits prevailed over growth of demand deposits. On an annual basis deposits placed with current accounts have increased by 11,7% term deposits increased by 17,3%. As at 1 October 2010 share of term deposits in total deposits was 62,2%, while as at 1 October 2009 this ratio was 59,3%. Overall stability of deposit base has increased its duration as well. Thus, 33,8% of total deposits are deposits with over 1 year maturity (32,3% as at 01.01.2010).

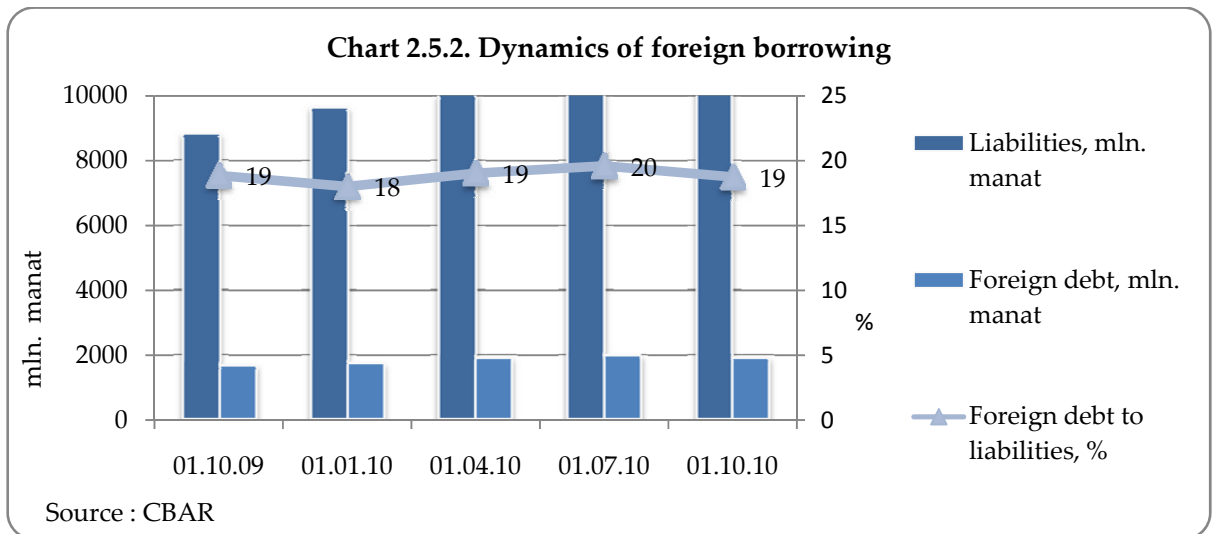
Maturity structure of savings of legal entities and individuals in banks bettering positive trends were observed in its currency structure as well. Thus, deposits of legal and individual customers in national currency increased by 11,1% within 9 months of the current year, share in total deposits made 45,1% (01.10.2009 - 35,7%, 01.01.2010 - 41,2%).

Within January – September deposits of the population in manats have increased by 29% and constituted AZN1,2bln as of 01.10.2010, deposits in foreign currency have increased by 13,4% and made up AZN1,6 bln. (Chart 2.5.1).



Volume of interbank liabilities increased by AZN325,8 mln. (19%) within January – September of the current year and constituted AZN2bln as at 01.10.2010. Ratio of the resources of the type to average assets makes 15-16%.

Net growth of funds attracted from non-residents within 9 months of 2010 constituted AZN176,6 mln (+10,2%). As of the end of the period volume of liabilities attracted from non-resident banks was AZN1,9 bln, share in total liabilities was 18,8% (Chart 2.5.2).

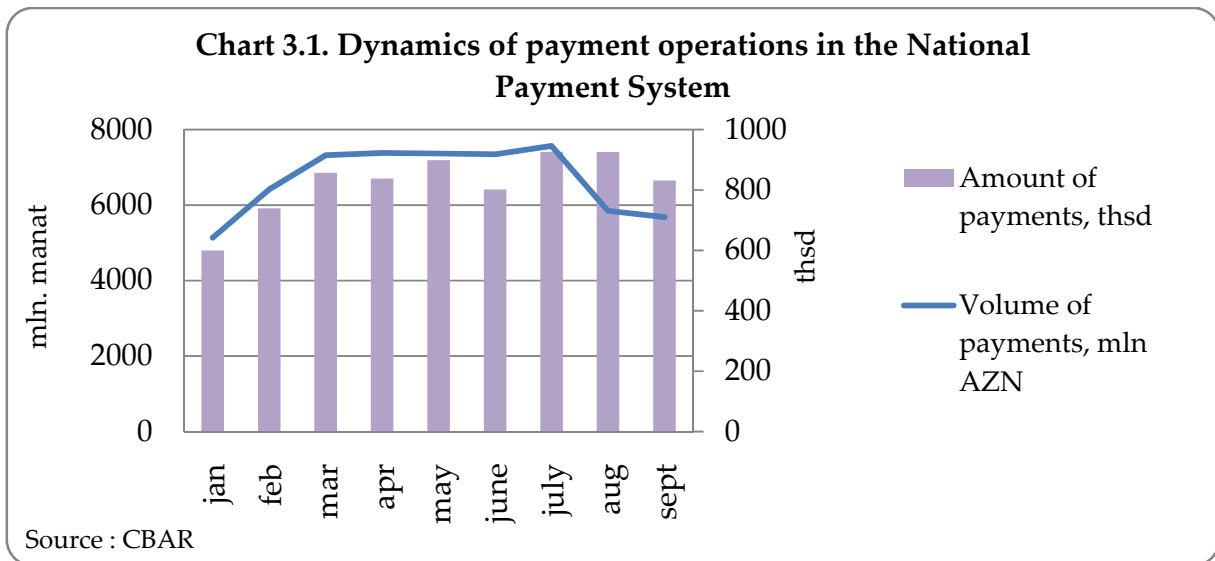


Despite revival of lending activity during Quarter II and III of the current year liquidity level of banks remained high. Ratio of liquid instruments to total assets confirms adequate management of liquidity risk in the banking sector. As before liquid assets take about 1/5 of total assets and cover 56% of deposits attracted from non-financial institutions and deposits of the population.

Maturity analysis of liquidity by assets and liabilities (GAP analysis) as well displays acceptable level of liquidity (in the range of -6,6%, +11%).

III. Payment systems

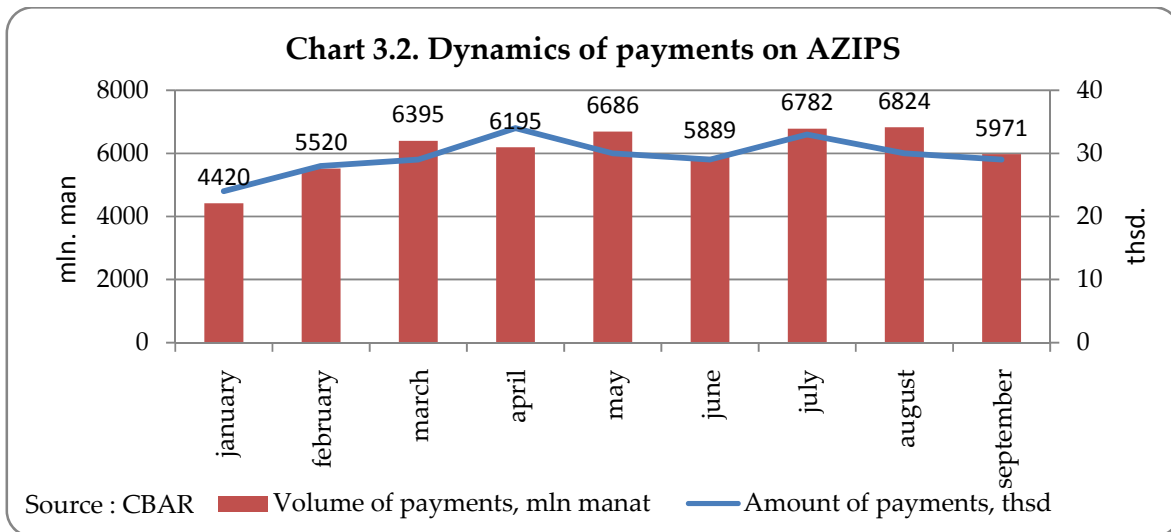
Within 9 months of 2010 growth tendency of the number and volume of payments in payment systems endured (Chart 3.1).



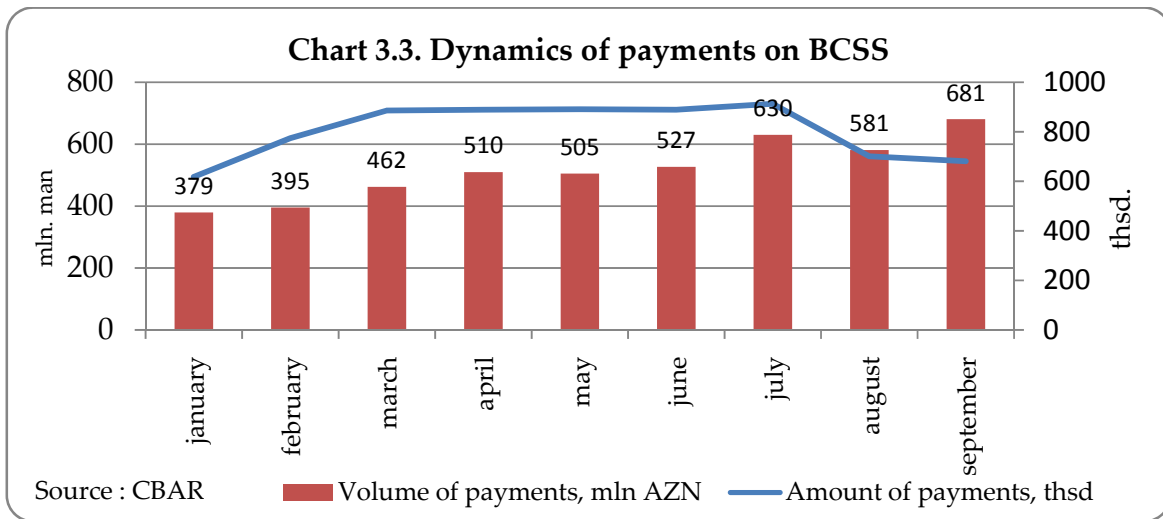
During the period 7,5 mln pieces of operations were provided in the National Payment System total amount being AZN59,35 bln. If to compare with the relevant period of the previous year the number of operations increased by 73% (3,18 mln. pieces), and volume by 8% (AZN4,27 bln). Within January – September 2010 on average 37,9 thousand pieces of operations were provided total volume of payments being AZN300 mln. man. (against relevant period on average respectively 21,9 thousand pieces and AZN 278,2 mln).

Through Large Value Payment System (AZIPS) that is of systemic importance for the country 92% of the volume of all non-cash payments and 3,5% of their number were conducted as non-cash settlements within 9 months of 2010 (266 thousand operations amounting to AZN54,68 bln) (Chart 3.2). This shows the capability of the system to provide large

volume and priority payments. If to compare with the similar period of the previous year the number of payments is 3,18 mln.pieces more and volume – AZN4,27 bln more. Amount per payment order made on average AZN205,4 thousand in the system within 9 months of 2010 which is 14% (AZN26 thousand.) more against the previous year.

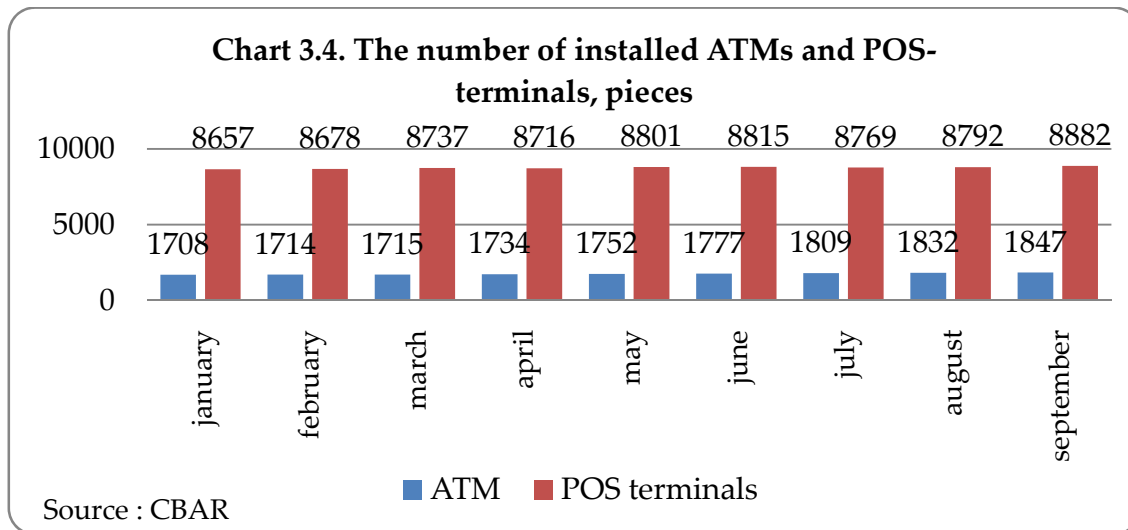


In Retail Payment System (BCSS) vast majority of all non-cash payments - 96,5% from the number standpoint, and 7,9% from volume standpoint (amount - AZN4,67 bln, 7,24 mln. pieces of orders) were processed as small volume non-cash settlement which displays assignment of the system to provide retail small payments (Chart 3.3). Amount per payment document in the system on average constituted AZN 655,2 man.



Development of payment systems in 2010 created condition to expand payment services. One of the key factors enabling this development is the infrastructure providing banking services. Positive trends in payment services is due to dynamic development of the infrastructure allowing to provide payments through payment cards (ATMs and e-terminals). During the reported period total 32,54 mln pieces of operations total volume being AZN4,06 bln were provided through ATMs and POS-terminals.

The number of ATMs installed in bank branches, in retail trade and service entities throughout the country has increased by 8% (139 pieces) against the year launch and constituted 1847 pieces, of which 1028 are installed in the city of Baku and 819 pieces in regions. On average 205 ATMs serve every 1 million of the population. The number of POS-terminals have increased by 2,6% (225) and constituted 8882 pieces and 987 POS-terminals serve 1 million of the population (Chart 3.4).



Within 9 months of 2010 the number of bank cards has increased by 42 thousand pieces and made 4,06 mln pieces. On average 451 payment cards fall into the share of every thousand persons. And 10,9 bank entities serve every hundred thousand of the population.

Volume of total turnover of operations conducted through remittance systems made AZN810,3 mln and the number 1,51 pieces.

During the reporting period 19,579 thousand operations amounting to AZN46,022 mln were provided through internet-banking.