



CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

FINANCIAL STABILITY REPORT

HALF I

2023

FINANCIAL STABILITY DEPARTMENT

Central Bank of the Republic of Azerbaijan

FINANCIAL STABILITY REPORT*

*** The Report is based upon data as of June 2023.**

ACRONYMS

| | |
|--|---|
| AEs – advanced economies | NBCI – non-bank credit institution |
| ADB – Asian Development Bank | NC – national currency |
| CBA – Central Bank of the Republic of Azerbaijan | OCP – open currency position |
| CA – capital adequacy | OVDL – overdue loans |
| CAR – capital adequacy ratio | pp – percentage point |
| DTI – debt-to-income ratio | ROA – return on assets |
| EMEs – emerging market economies | ROE – return on equity |
| FX – foreign Exchange | RWA – Risk weighted assets |
| GDP – gross domestic product | SCC – State Customs Committee |
| GS – government securities | SOFAZ – State Oil Fund of the RA |
| HP – Hodrick-Prescott filter | SSC – State Statistics Committee |
| IMF – International Monetary Fund | WB – World Bank |
| LE – legal entity | yoy – year over year |
| MCGF – Mortgage and Credit Guarantee Fund of the Republic of Azerbaijan | |
| MSME – Micro, small, and medium enterprises | |
| MLSP – Ministry of Labor and Social Protection of the Population | |
| NPL – non-performing loans | |
| NGS – non-government securities | |

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Executive summary

In H1 2023 the global economic environment was shaped on the backdrop of lingering geopolitical and geoeconomic pressure, monetary policy tightening in major countries, economic growth weakening and shrunk financing opportunities. Global energy prices fell, and global trade weakened amid the shrinkage of the industrial production over the first half of the current year. The CBA implemented a policy oriented towards safeguarding macroeconomic and financial stability under its mandate in the environment of complex activities.

Over the reporting period the financial system preserved its resilience against external shocks and sector's financial stability strengthened.

The macro and micro prudential policy implemented by the CBA conditioned higher financial resilience of the banking sector. Over the period factors that have a positive effect on financial stability included banking sector capitalization measures, removal of one insolvent bank from the sector, heightened prudential requirements on the risks that formulate sensitivity zones, an intense dialogue with the sector and initiatives oriented towards the improvement of corporate governance, as well as reforms to make pass through capacity of monetary policy decisions.

Over the first half of the year all segments of the lending portfolio of the banking sector posted growth. Changes made to the macroprudential regulatory framework and effective risk management by credit institutions amid high dynamics of the lending portfolio supported credit risk stability of the sector.

Historical lows of the dollarization of the deposit and lending portfolios of the banking sector and the open currency position being within prudential requirements elevated resilience of banks against market risk shocks. Interest rate sensitivity of the banking sector is not jeopardizing the resilience of the sector. Liquidity indicators, which are in the comfort zone, are playing a key role in increasing the lending activity of the banking sector.

Profitability of the sector was in a positive zone, the capital position prevailed over prudential requirements. High capital buffer allows absorbing potential risks.

The penetration and the depth of the insurance sector improved in parallel with improved financial indicators of the sector. The investment portfolio accounted for 75% of assets of the sector, which increases the role of the sector as an institutional investor in the financial system. Profitability of the sector increased, and capital indicators continued prevailing over prudential requirements.

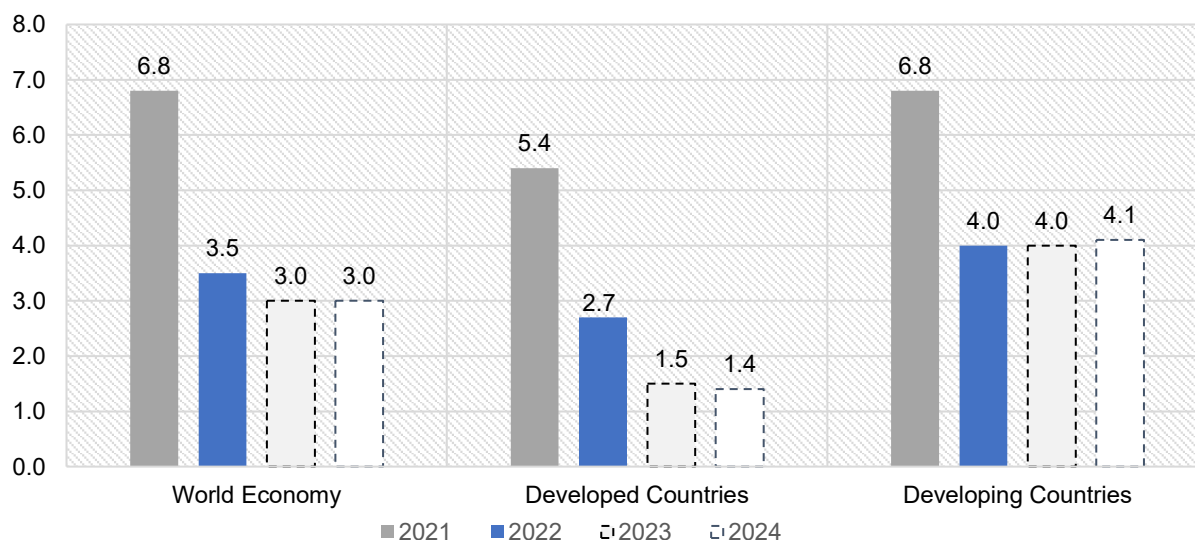
Circulation of securities in the capital market expanded on the backdrop of the rise in repo/reverse repo operations and circulation of corporate securities in the primary market. Financial indicators improved, amid high profitability of the sector and expansion of its balance sheet. The capital position of the sector was in a comfort zone.

Global macroeconomic environment

In H1 2023 the global economy was shaped under lingering geopolitical and geoeconomic conflicts, uncertainties in the global economy and the tight monetary policy. Although recovery of the global supply chain supported economic growth during the post-pandemic period, the continuing Russia-Ukraine conflict, as well as the monetary policy tightened in response to rising inflationary pressures, weighed on economic activity. Despite earlier than expected recovery of economic activity in China and ongoing rise in US consumption, global economic growth is expected to drop in 2023. Banking stress in AEs is indicative of the fact that borrowing conditions will also tighten. According to the IMF, the growth rate of the global economy (it grew by 3.5% last year) is forecast to be around 3% in 2023 and 2024.

Global financing opportunities shrank amid the tight monetary policy and decisions of central banks to increase policy rates. Global funding conditions

Chart 1. Global GDP growth forecast, in percentage



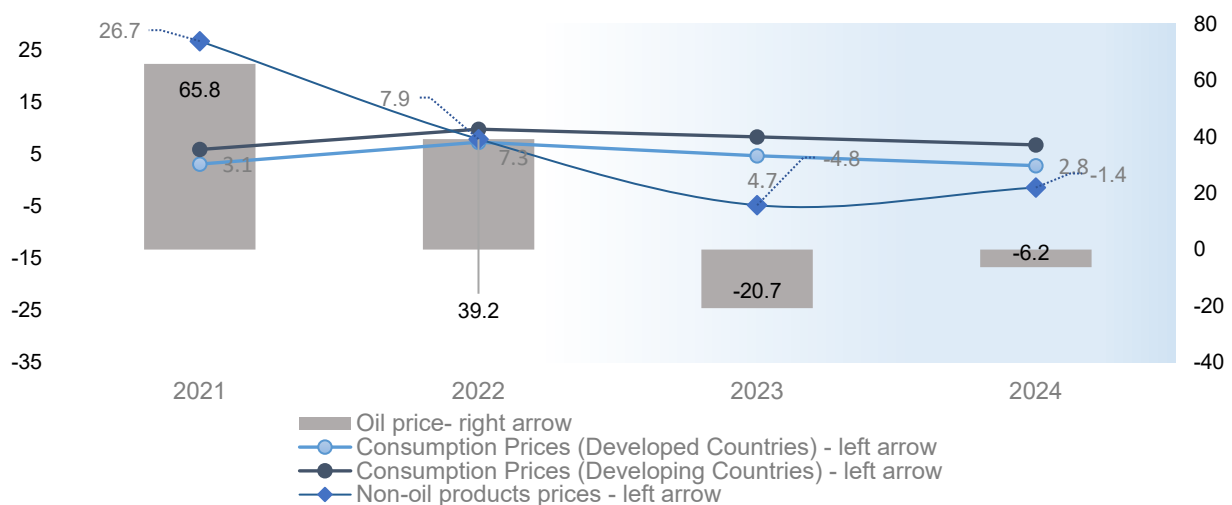
Source: IMF WEO

contracted due to the most accelerated monetary tightening since 1980s, leading to the inversion of the US yield curve. Most banks in AEs started the year of 2023 with unrealized loss in their bond portfolios due to rising interest rates. On the backdrop of factors threatening the sustainability of bank balances, bank run of depositors in the USA and Europe at the beginning of the year triggered financial market volatility. In general, global financial markets remain sensitive to interest rate decisions of central banks.

Inflation was higher than the target band in all countries. Despite gradual removal of supply chain disruptions and relative drop in energy prices, excess demand paved the way to persistent high inflation. Easing of inflation indicators in Q1 2023 is attributable to the relative drop in energy prices. If to consider the above, whereas global inflation is forecast to follow a downward dynamic in upcoming years, it will be higher than the average indicator of 2015-2019 (3.14%) for a long time. Surveys conducted in US and European countries suggest that inflation expectations of consumers for a medium run are stable in 2023. Inflation in EMEs kept rising or was high. Despite the removal of adverse effects of supply chain and the drop in energy prices, core inflation remained high.

Global trade weakened in response to low industrial production in H1 2023. The services sector continued strengthening amid the removal of pandemic restrictions. The pressure lessened with lower aggregate demand in the global supply chain and gradual removal of downtimes in cargo transportation. The global economic activity, in particular interest rate sensitive areas (business lending, mortgage, construction) are slowing down due to the tightened monetary condition. Economic growth is expected to decrease by 0.8% in AEs in 2023 amid the tight monetary condition, shrinking lending and high energy prices.

Chart 2. Commodity price change, in percentage



Source: IMF WEO

Consumption of natural gas and power decreased amid low economic activity and mild winter, resulting in lower energy prices compared to the peak in 2022. In H1 2023 oil prices were driven by economic growth uncertainties and output cut by Saudi Arabia and OPEC+ early in April. The oil price is forecast to be \$82/b in 2024. Natural gas and coal prices are expected to stabilize in 2023 and decrease in 2024. Despite significant efficiency gains in lower energy consumption in Europe, natural

gas prices in Europe are expected to be higher than the five-year average before the pandemic. Metal prices are forecast to decrease in 2023 and 2024, but to be higher than the average of 2015-2019.

Fiscal deficit is falling in AEs. The gradual suspension of fiscal stimulus due to the end of the pandemic supported the reduction of fiscal deficit in countries across the world. Nevertheless, the rise in interest rates by central banks and the tightening of financial conditions in global markets increase the debt burden of EMEs.

Table 1. Share of fiscal balance and state debt in GDP, in percentage

| | Fiscal balance | | | | State debt | | | |
|------------------------------------|----------------|-------------|-------------|-------------|--------------|--------------|--------------|--------------|
| | 2021 | 2022 | Forecast | | 2021 | 2022 | Forecast | |
| | | | 2023 | 2024 | | | 2023 | 2024 |
| AEs | -7,5 | -4,3 | -4,4 | -4,2 | 117,4 | 112,5 | 112,4 | 113,6 |
| USA | -11,6 | -5,5 | -6,3 | -6,8 | 126,4 | 121,7 | 122,2 | 125,8 |
| Euro area | -5,4 | -3,8 | -3,7 | -2,8 | 94,9 | 90,9 | 89,8 | 89,0 |
| Japan | -6,2 | -7,8 | -6,4 | -4,0 | 255,4 | 261,3 | 258,2 | 256,3 |
| EMEs | -5,2 | -5,2 | -6,8 | -6,3 | 64,3 | 64,6 | 67,5 | 69,8 |
| Asia | -6,5 | -7,4 | -7,0 | -7,2 | 71,5 | 75,1 | 79,1 | 82,6 |
| Europe | -1,9 | -2,8 | -5,2 | -4,4 | 34,7 | 32,8 | 36,9 | 37,9 |
| Latin America | -4,5 | -3,9 | -4,7 | -4,0 | 71,9 | 69,7 | 68,6 | 69,3 |
| Middle East and North Africa | -2,1 | 2,6 | -1,0 | -1,7 | 52,1 | 43,0 | 42,5 | 41,2 |

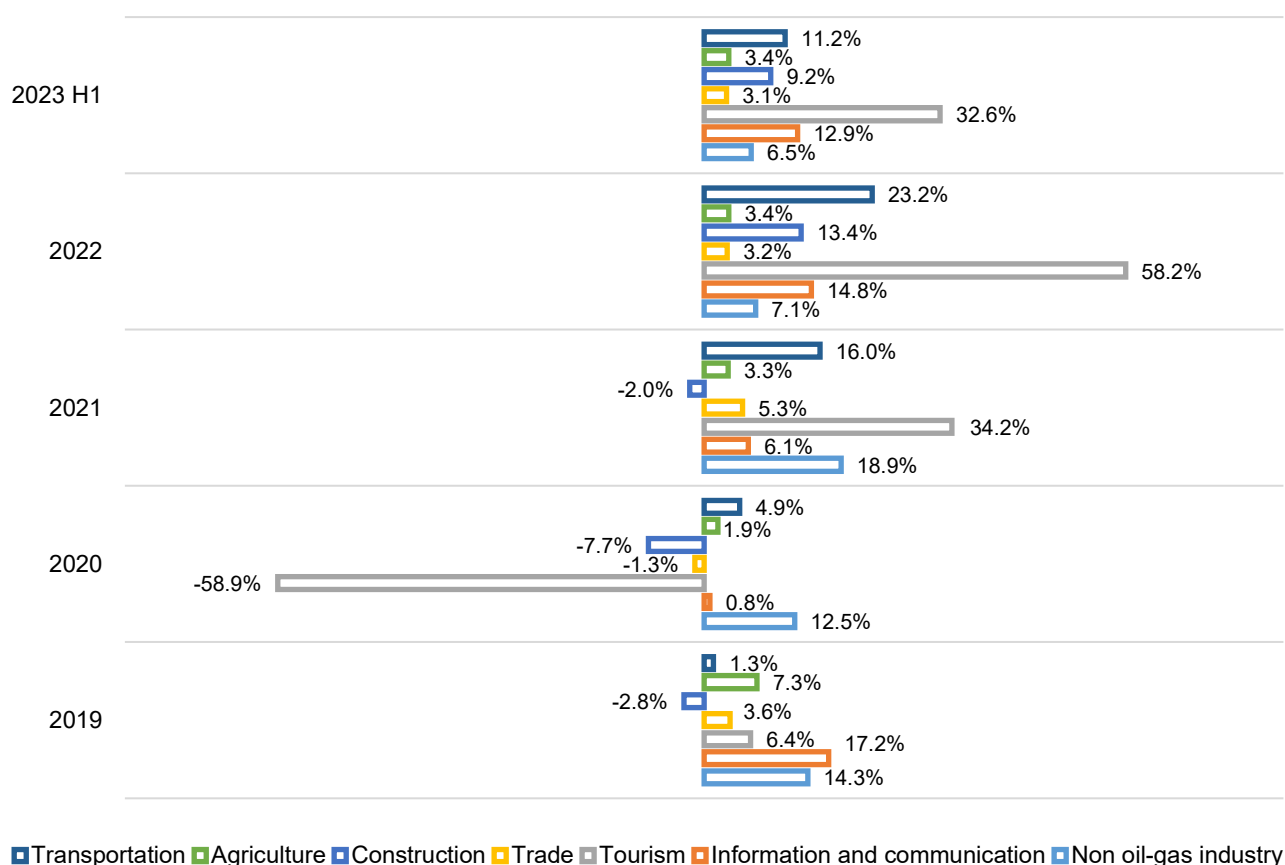
Source: IMF, Fiscal monitor, April 2023

Macroeconomic environment in Azerbaijan

In H1 2023 the Azerbaijani economy was driven by uncertainties triggered by global geopolitical and geoeconomic risks, weaker global economic activity, energy price volatility, including high inflationary pressures. Over the period real GDP increased by 0.5% to nominal AZN60.3B. Economic growth was driven by the non-oil and gas sector. The oil-and-gas value added decreased by 2.1%, while non-oil and gas increased by 3.1%. The non-oil and gas sector accounted for 60% of GDP. Per capita GDP amounted to AZN5.9 thousand.

Most areas of the non-oil and gas sector posted growth year over year in 2023. The highest growth was in tourism (32.6%), attributable to the rapid post-pandemic development of this sector in our country. The non-oil and gas industry grew by 6.5%. Tourism, information, and communication also developed fast.

Chart 3. Non-oil economic growth, in percentage



Source: SSC

Nominal income of the population and salaries continued growing. As of end-Q2 2023 labor force numbered 5224.4 thousand persons, out of which the number of employed population was 4934.5 thousand persons. Salaried labor was 1726.3 thousand persons, 52% (898.6 thousand persons) was engaged in the public sector and 48% (827.7 thousand persons) in the non-public sector. Average monthly nominal income of salaried labor increased by 11.1% to AZN916.8. Nominal income of the population yoy increased by 14.7% to AZN37.9B.

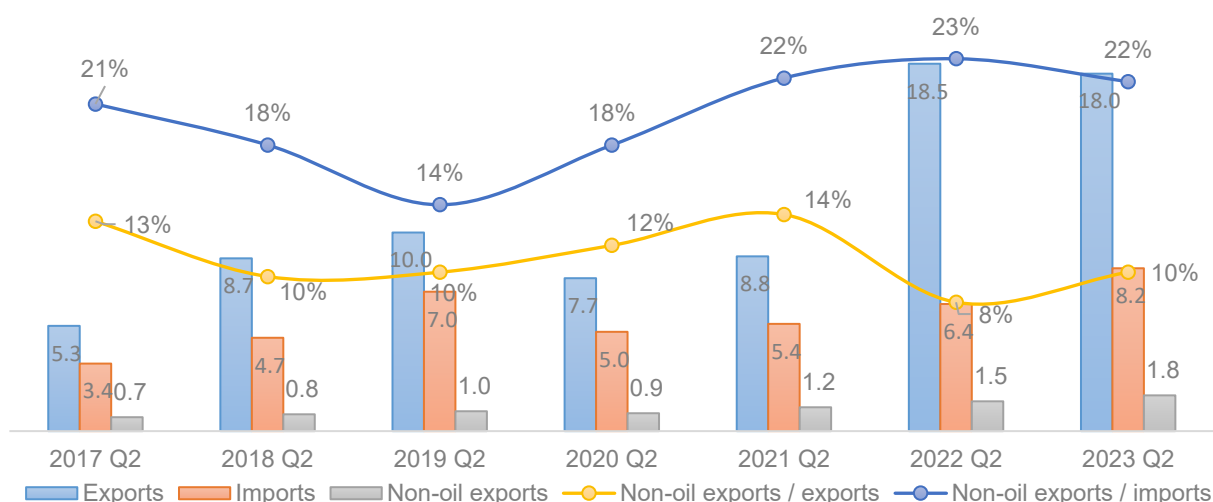
Though decreased year over year, inflation remains higher than the pre-pandemic period. According to the SSC, in June 2023 annual inflation stood at 10.6% (June 2023/June 2022), down by 5 pp compared with the peak inflation in September 2022. Average annual inflation stood at 12.7% (January-June 2023/January-June 2022). Annual and average annual core inflation was 11.1% and 12.5% respectively.

Inflation fell due to both internal and external factors. Lower inflation in partner countries, price slide in global commodity markets, return of international cargo transportation costs to the pre-pandemic levels drove inflation down. In June 2023 average weighed inflation in trade partner countries were estimated to drop by more than two times compared with the peak rate in October 2022, attributable to weaker global economic activity, drop in global energy prices and the tight monetary policy in most countries. In general, stronger factors that drive inflation down contributed to the reduction of inflation forecast.

The CBA continued the anti-inflationary monetary policy efforts. In H1 2023 interest rate parameters were discussed four times. The Bank decided to shift the refinancing rate to 9% from 8.25%, the floor of the interest rate corridor to 7.5% from 6.25% and the ceiling to 10% from 9.25%. Over the reporting period the Bank continued to apply monetary policy tools under a new configuration. Demand for liquidity absorbing standing facilities of the CBA was higher than for other tools.

To regulate money supply more effectively and pave the way to more effective application of the new operational framework, the Bank changed the procedure and level of differentiation of the reserve requirement. The reserve requirement on deposits of legal entities was increased upon differentiation.

Chart 4. Dynamics of import and export, billion US dollars



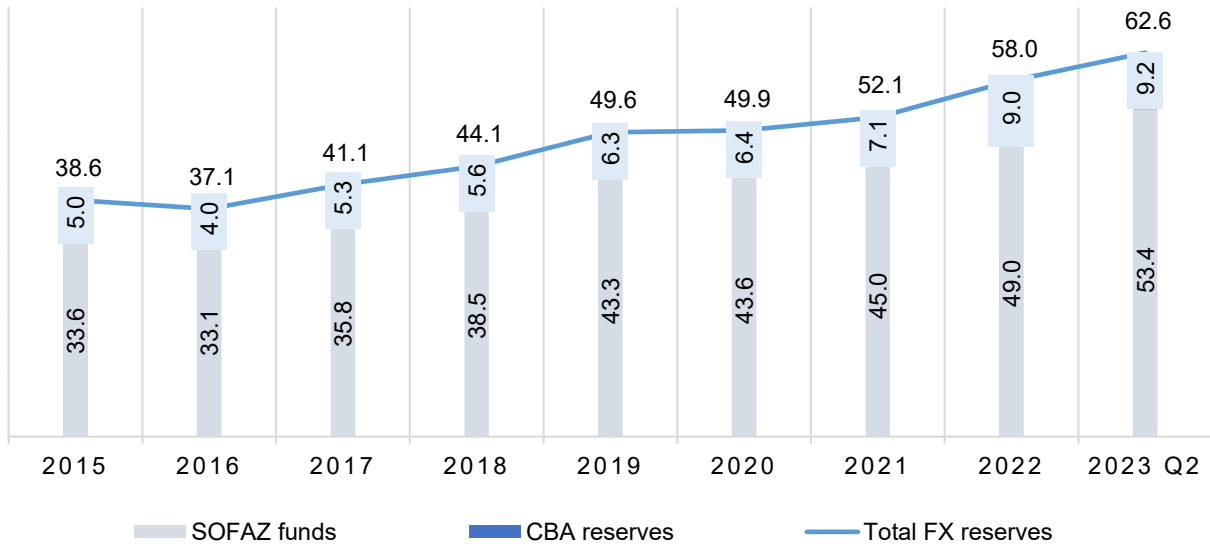
Source: SCC

The non-oil and gas export continued to grow. According to the SCC, in H1 2023 export yoy decreased by 3% (\$0.5B) to \$18B, while import increased by 28% (\$1.8 B) to \$8.2B. Export of non-oil and gas products yoy increased by 20% to \$1.8B.

Indicators of the balance of payments improved. In H1 2023 current account surplus amounted to \$5.2B, 14.5% of GDP. Surplus on remittances made to \$636M.

Long-term growth of FX reserves continued. The growth of FX reserves under way since 2016 lingered. Growth was driven by funds of the SOFAZ and FX reserves of the CBA. FX reserves of the CBA increased by 2.2% to \$9.2B, while reserves of the SOFAZ increased by 9% to \$53.4B. In total, FX reserves of the country increased by 7.9% to \$62.6B, the highest indicator of recent years.

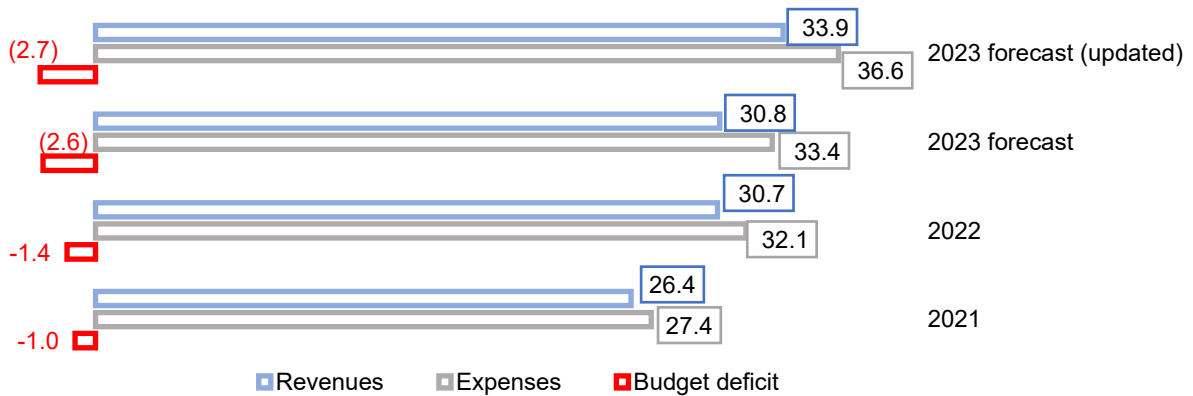
Chart 5. FX reserves of the CBA and the SOFAZ, billion USD



Source: CBA, based on SOFAZ data

Fiscal expenses were increased to accelerate the restoration of liberated territories. Amid support for economic growth, actions taken to boost well-being of the population and restoration of liberated territories, initially state budget revenues made AZN30.8B, while expenses made AZN33.4B. However, a law on making changes to the budget was adopted in June 2023, to accelerate the restoration of liberated territories and strengthen defense capabilities. Thus, updated budget revenues were increased by AZN3.2B to AZN33.9B, and updated budget expenses were increased by AZN3.2B to AZN36.6 B.

Chart 6. State budget revenues and expenses, billion AZN

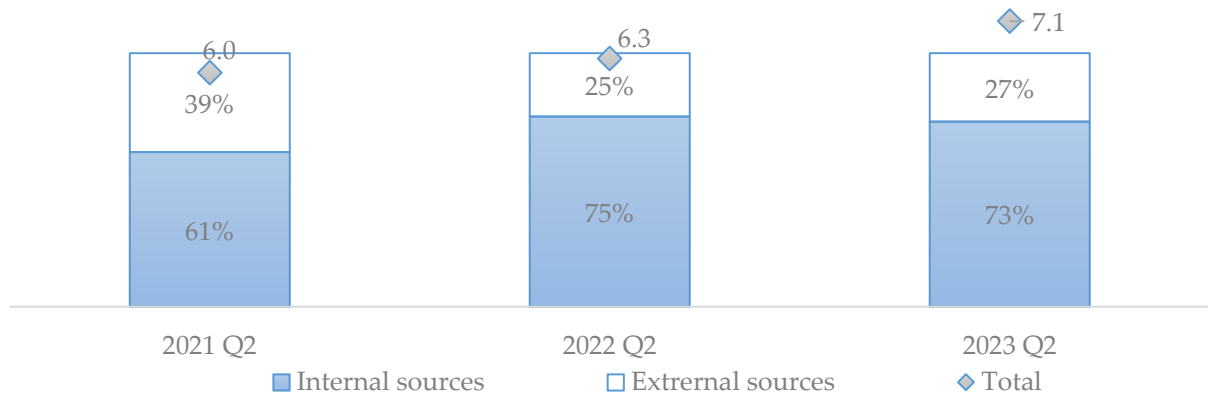


Source: CBA, based on SSC data

According to the SSC, in H1 2023 total investments for economic and social area development amounted to AZN7.1. In general, AZN5.2B (72.9%) worth investments were financed from internal sources. Non-oil investments increased by 4.2%.

Although uncertainties related to the global geopolitical and geoeconomic situation, and a high global inflation rate remains a risk, foreign trade surplus and the rise in strategic FX reserves allow to safeguard macroeconomic stability.

Charter 7. Structure of investment to capital, billion AZN



Source: SSC

Overview of the banking system

In H1 2023 main banking sector indicators followed positive trends. While the size of liquid assets of the banking system slightly decreased over 6 months of the year, quality of and return on assets was favorable, liquidity and the capital position exceeded prudential requirements. Analyses suggest that the banking sector resilience to external shocks is high.

- The role of the banking system in financial intermediation:

There is a bank-based funding model in the country. The banking system still plays a key role in the financing of the economy. The bank assets to GDP ratio (one of the main indicators to characterize financial depth of the banking sector) was 37.5%. At the same time, another financial depth indicator – the lending portfolio to GDP ratio was 17.7% (the lending portfolio to non-oil GDP is 29.5%). Financial depth indicators of the Azerbaijani banking sector are lower than in benchmark countries, expressive of future growth potential of the banking sector.

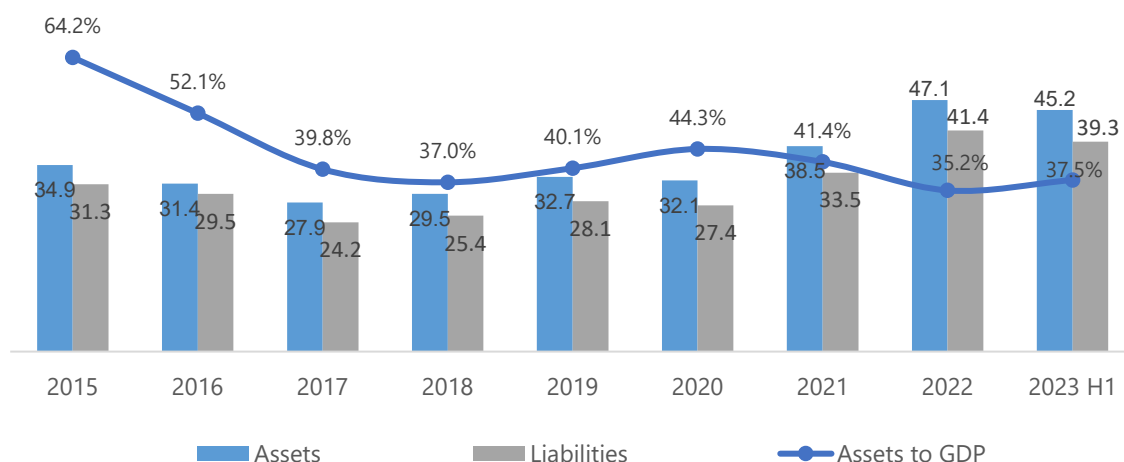
A license of one bank that had lost its resilience was revoked over 6 months of the year. There are 24 banks in the country, two of which are state-owned banks. The number of banks with foreign capital is 9, and there is a local branch of one foreign bank. The service network of the sector includes 487 branches, 74 divisions, 3009 ATMs, and 23.2 thousand employees. The number of branches per 1000 km² territory is 6, the number of ATMs per 100 thousand persons is 30. The service network has not expanded year over year (if to skip the removal of 1 bank from the sector, there was no considerable rise in branch network, the number of ATMs increased by 0.4%). attributable to the rise in digital service solutions in the banking sector (banks' mobile applications improved, digital card offers increased etc.).

- Dynamics of banking sector assets and liabilities

Whereas in Q1 2023 the balance sheet of the banking system slightly contracted due to the drop in demand deposits of large companies, in Q2 the balance sheet of the sector increased compared with Q1. Over the first half of the year banking sector assets decreased by 3.9% (AZN1.8B) to AZN45.2B. Total assets of banks decreased by 4.7 % (AZN2.2B) in Q1 and increased by 0.8% (AZN0.4B) in Q2. Contraction of the balance sheet related to the drop in demand deposits of large companies engaged in the oil and gas sector; demand deposits of legal entities decreased by 18.3% (AZN3.6B) to AZN16.1B. At the same time, liquid assets of the sector decreased by 19% (AZN-3.3B) to AZN14B. Banking sector liabilities decreased by 5.1% (AZN-2.1B). As of 30.06.2023 banks' total liabilities amounted to AZN39.3 B.

However, financial intermediation of the sector is expanding – the lending portfolio increased by 8.7% (AZN1.7B) to AZN21.3B.

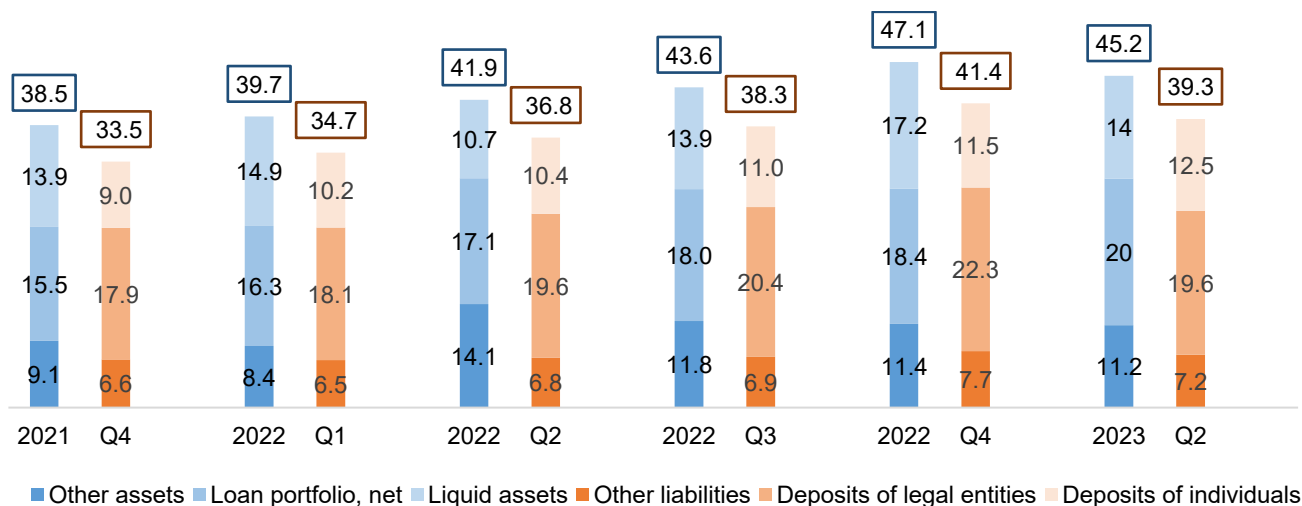
Chart 8. Dynamics of banking system assets and liabilities, billion AZN



Source: CBA

Banking sector assets consist of net lending portfolio (44%), liquid assets (31%), deposits placed with and loans of financial institutions (11%) and other assets (13%). Bank liabilities include deposits of legal entities (current accounts prevailing). Deposits of legal entities account for 50%, deposits of individuals for 32%, amounts due to financial institutions for 12% and other liabilities for 6% of total liabilities.

Chart 9. Dynamics of the structure of banking system assets and liabilities, billion AZN

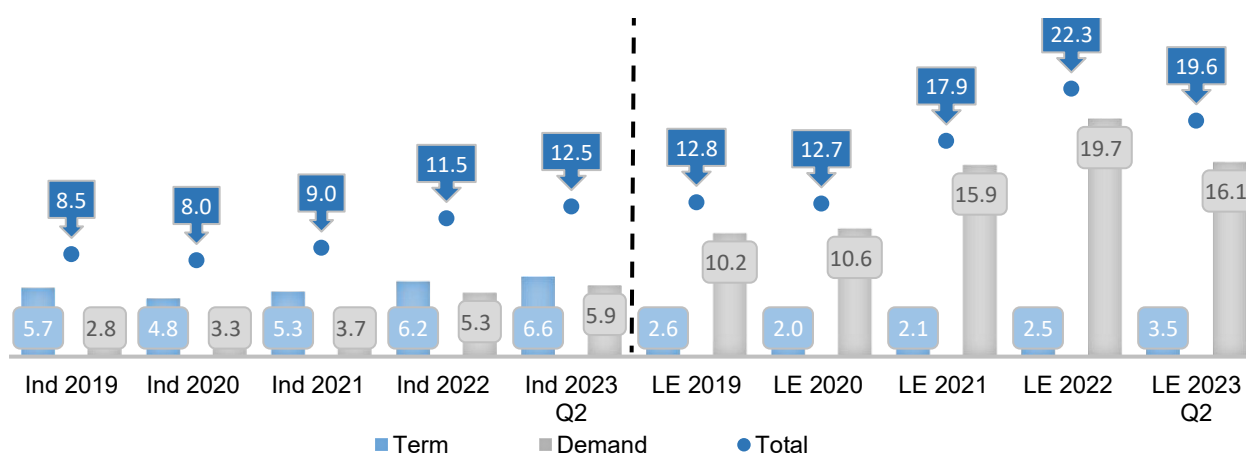


Source: CBA

- **Resources attracted across the banking sector**

The drop in the deposit portfolio was attributable to demand deposits of legal entities. In H1 2023 the deposit portfolio decreased by 5.1% (AZN1.7B) to AZN32.1B. Although the deposit portfolio decreased, the share of the portfolio in total liabilities increased by 0.1 pp compared with the end of last year to 81.6%. Deposits of legal entities were the key in the deposit portfolio as at the end of 2022. Deposits of legal entities accounted for 61% (AZN19.6B), deposits of individuals for 39% (AZN12.5 B) of the deposit portfolio. 68.6% (AZN22B) of banking sector deposits included demand deposits (82.2% for legal entities), which in its turn, condition maintenance of a high liquidity buffer by banks.

Chart 10. Dynamics of the deposit portfolio of individuals and legal entities, billion AZN



Source: CBA

Whereas deposits of legal entities decreased, they still play a key role in financing of banks. Over the reporting period deposits of legal entities decreased by 12.1% (AZN2.7B) to AZN19,6B, and the share in total liabilities was 50%. The main reason for the drop in deposits of legal entities was 18.3% (AZN3.6B) drop in demand deposits of legal entities, attributable to project financing of the companies engaged in the oil and gas sector. Despite the drop in demand deposits of individuals, term deposits of legal entities, which are less liquidity sensitive, increased by 35% (AZN0.9B). The CBA focuses on high concentration of demand deposits of legal entities.

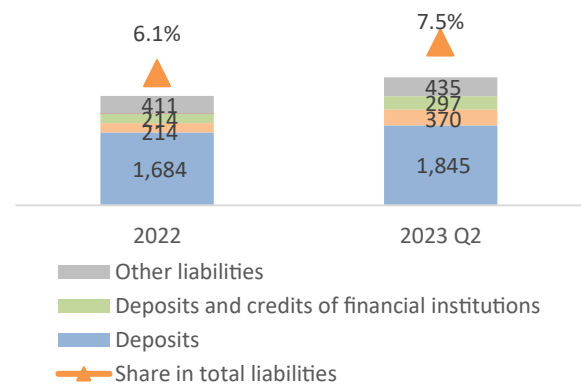
Amid high confidence of the population in the banking sector, deposits of individuals reached historical highs. In the first half of the year the deposit portfolio of individuals increased by 8.6% (AZN1B) to AZN12.5B (31.8% of liabilities of the sector). Term deposits accounted for 53% (AZN6.6B) and demand deposits for 47% (AZN5.9B) of the deposit portfolio of individuals. Growth of the deposit portfolio of individuals was driven by demand deposits of individuals. Demand deposits of individuals increased by 11.3% (AZN0.6B) compared the end of last year to AZN5.9B,

and term deposits of individuals increased by 6.3% (AZN0.4B) to AZN6.6B. Growth in demand deposits of individuals was driven by the rise in debit card operations amid higher demand for cashless operations. Over the reporting period dollarization of deposits of individuals kept falling. On the backdrop of higher confidence of the population in the financial system and the national currency, dollarization of the total deposit portfolio of individuals decreased by 2.7 pp to 37.1%, dollarization of demand deposits of individuals decreased by 3.4 pp to 37.4% and dollarization of term deposits of individuals decreased by 2.1 pp to 36.9%.

Deposits of non-residents increased.

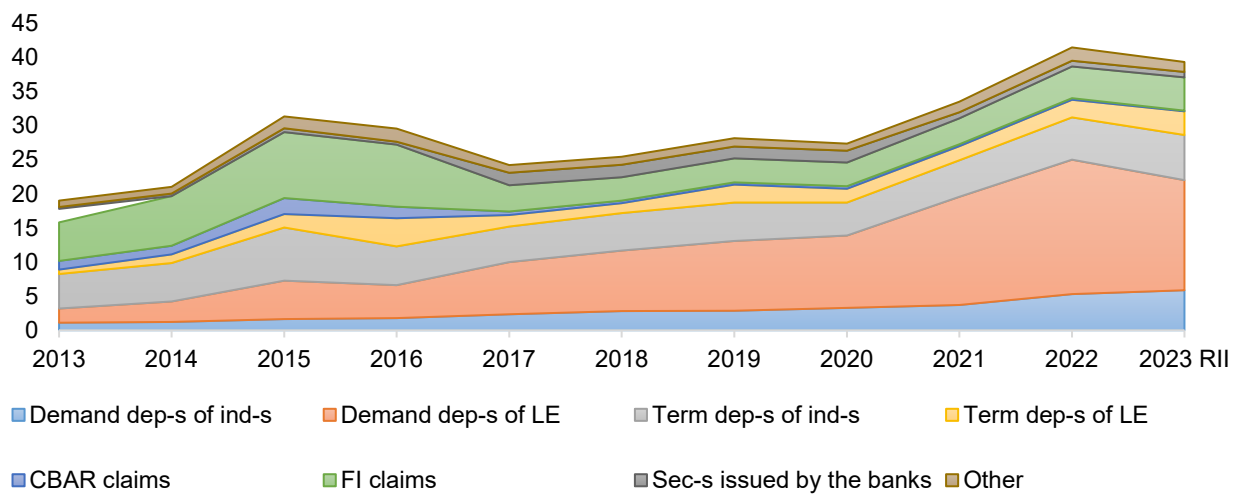
The share of resources attracted from non-residents in total liabilities of the banking sector increased by 1.4 pp to 7.5% compared with the end of 2022. Thus, nominal growth is driven by deposits and loro accounts of non-residents with banks. Deposits of non-residents with banks increased by 9.6% (AZN161M) to AZN1845M, while funds in loro accounts increased by 73.1% (AZN156M) to AZN370M compared with the end of last year.

Chart 11. Dynamics of resources attracted from non-residents, million AZN



Source: CBA

Chart 12. Dynamics of the structure of funds attracted across the banking sector, billion AZN

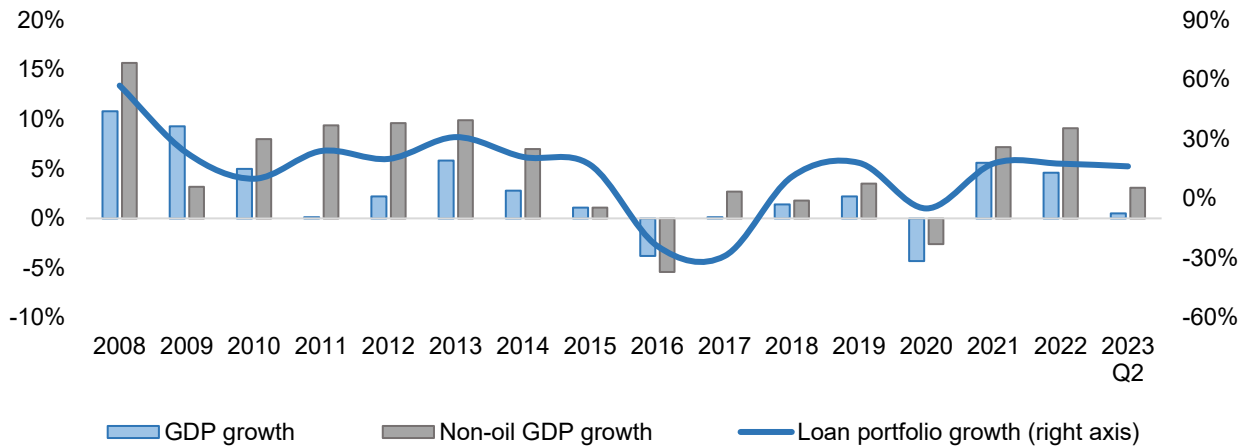


Source: CBA

- **Bank lending**

The lending portfolio kept increasing. In Half I 2023 the lending portfolio of the banking system increased by 8.7% (AZN1.7B) to AZN21.3B. Despite the decrease in annual economic growth rate, the annual dynamics of lending remained stable.

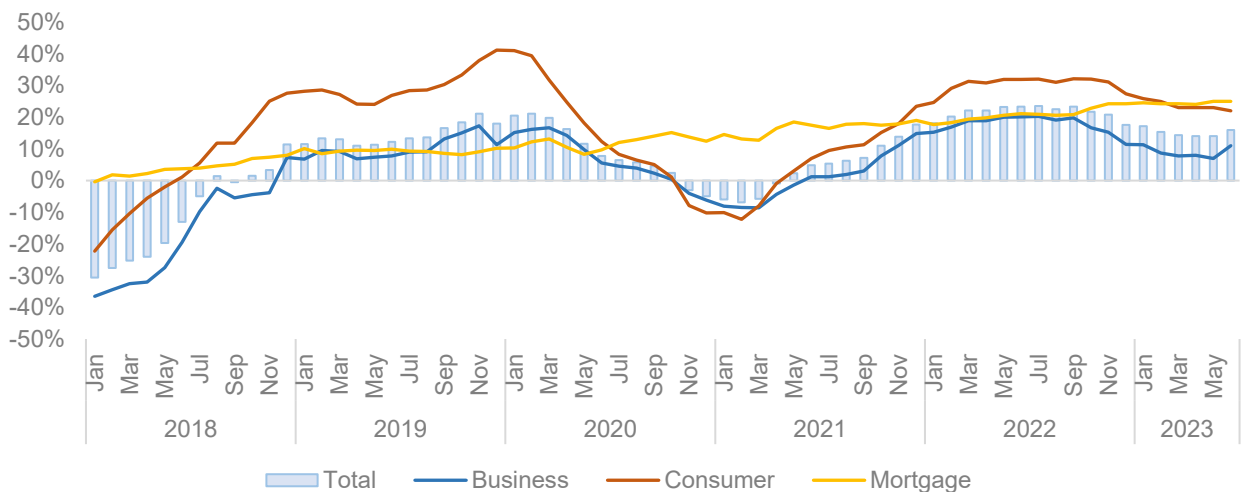
Chart 13. Comparison of the annual growth rate of the loan portfolio and GDP



Source: CBA

All segments of lending follow positive dynamics. The growth dynamics of the consumer portfolio is falling due to the tightening of the regulatory framework on consumer lending (before changes to the regulatory framework average monthly growth rate on the consumer portfolio was 2.3% and after the changes – 1.6%). The growth rate of business loans accelerated in Q2, while that of mortgage lending remained stable.

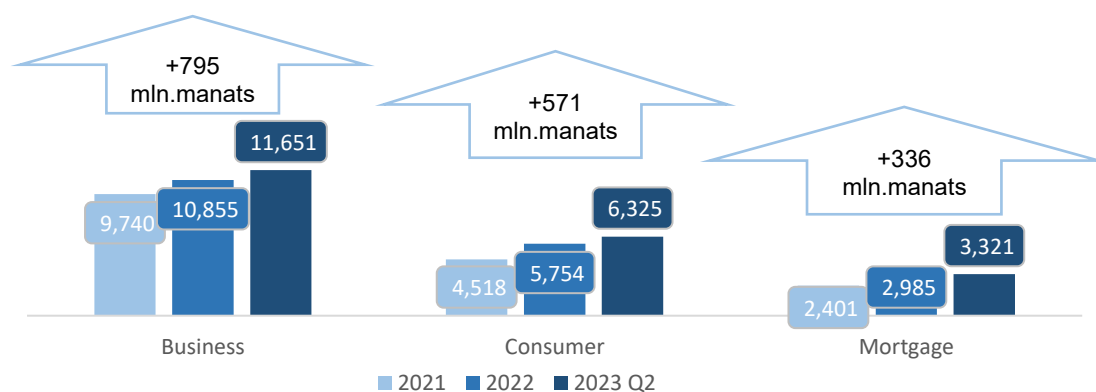
Chart 14. Annual dynamics of the loan portfolio, in percentage



Source: CBA

Business loans increased by 7.3% (AZN795M) to AZN11.7B. Over the reporting period the mortgage portfolio increased by 11.3% (AZN336M) to AZN3.3B, driven by state mortgage program (45%, or AZN150M) and by banks' own funds (55%, AZN186M). The consumer lending portfolio increased by 9.9% (AZN571M) to AZN6.3B.

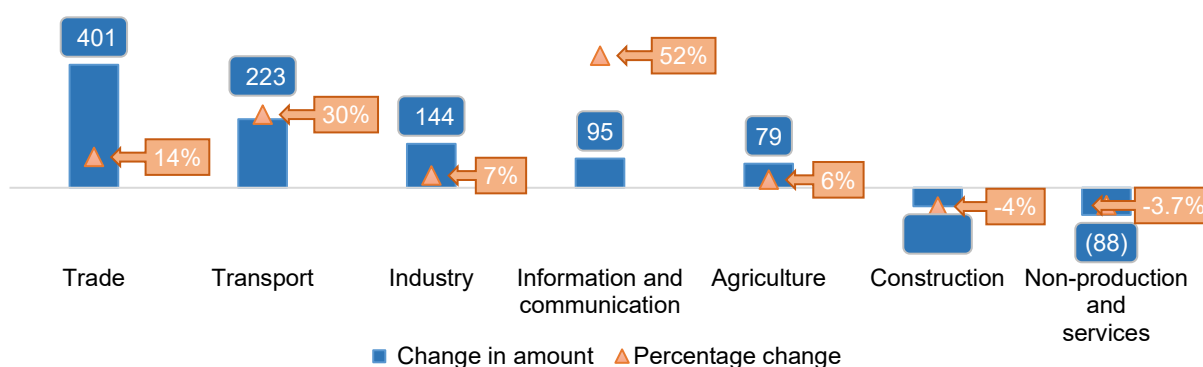
Chart 15. Loan portfolio dynamics, million AZN



Source: CBA

The business portfolio kept growing. Business loans accounted for 55% of the total portfolio. The business portfolio growth was driven by the trade (14% or AZN401M) and transportation sectors (30% or AZN223 M). Growth on these two sectors accounted for 78.5% of total growth of the business portfolio. The lending portfolio increased on industry, information, and agriculture by AZN144 M, AZN95M and AZN79M and decreased on construction and services by AZN60M and by AZN88M, respectively.

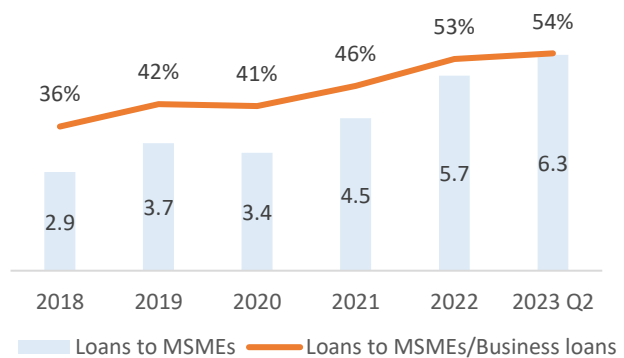
Chart 16. Annual dynamics of the business portfolio, million AZN



Source: CBA

In H1 2023 MSME lending reached highs of recent years. MSME loans increased by 10.5% (AZN0.6B) to AZN 6.3B compared with the end of last year (54% of the business portfolio). One of the main factors for the rise in the share of MSME loans in the business portfolio was the easing of MSME standards.

Chart 17. Dynamics of MSME lending, billion AZN

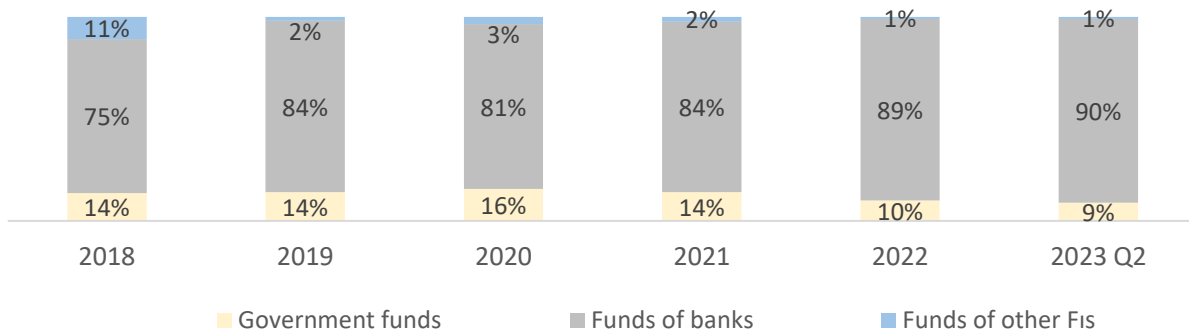


Financing of MSMEs from banks' own funds kept growing. As in recent years, banks continued to lend to MSMEs from their own funds in H1

Source: CBA

2023 too. The size of loans issued from banks' own funds from end-2022 to end-June 2023 increased by 13% (AZN656M) to AZN5.7B. Consequently, the weight of MSME loans issued from banks' own funds increased by 1 pp to 90%.

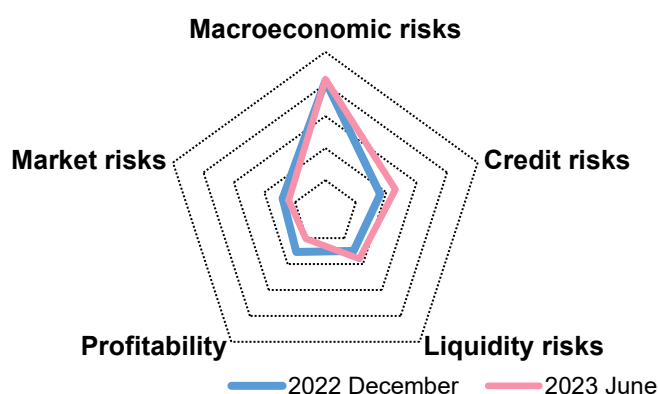
Chart 18. The structure of MSME loans in terms of funding sources



Source: CBA

Risk mapping of the banking sector

Chart 19. The risk mapping of the banking sector



Not: risks decrease close to the center

Source: CBA

Macroeconomic risks:

Main macroeconomic risks include uncertainty triggered by complicated geopolitical and geoeconomic developments and high inflation. At the same time, the adequate monetary and fiscal policy reduces macroeconomic stability risks.

Credit risks:

There were no considerable changes in the nominal level of credit risks on the backdrop of lending portfolio expansion. Although write-offs on the loss loan portfolio contribute to the improvement in the lending portfolio quality, sensitivity zones remain. The CBA keeps on focus the quality of the portfolio, the provisioning level, and the restructured portfolio.

Profitability position:

Growth of the net interest margin improved banking system profitability. The Bank keeps on focus the structure of banks' gains and losses and possibilities for increasing operational effectiveness.

Market risks:

The improved OCP of the sector and de-dollarization contribute to the fall in market risks. Dollarization of the deposit and lending portfolios is concentrated in a limited number of banks.

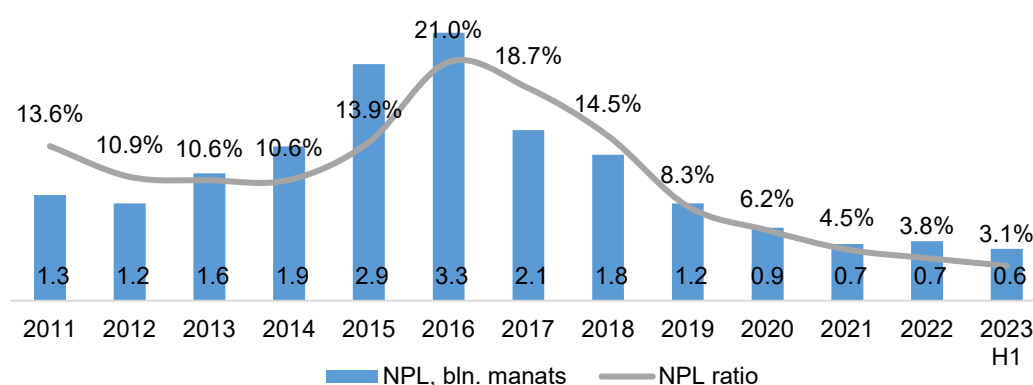
Liquidity risks:

Whereas total liquid assets of the sector decreases, the sector's liquidity buffer is high. The new monetary policy framework has a positive effect on liquidity distribution in the sector.

Credit risk of the banking system

The level of credit risks remained unchanged. In H1 2023 the NPL portfolio decreased by 0.7% to AZN0.7B. The share of the NPL portfolio in the total portfolio decreased by 0.4 pp to 3.4%. At present, the NPL ratio reached historical lows. The drop in the NPL portfolio was driven by removal of insolvent banks from the banking system and write-off of bad loans from the balance sheet, along with the improvement of the risk management framework in banks. Banks made AZN43M worth write-offs over six months.

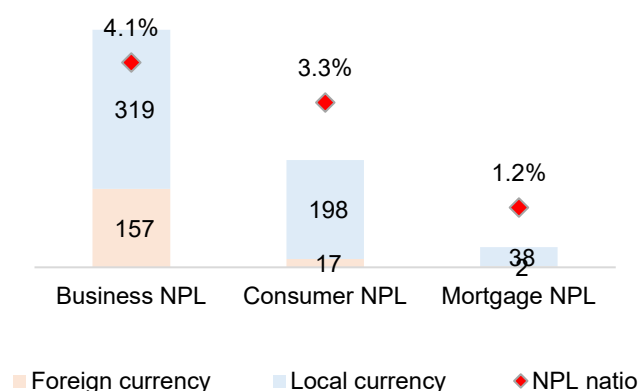
Chart 20. Dynamics of the NPL portfolio in the banking sector



Source: CBA

The business portfolio accounted for 65% (AZN0.5B), the consumer portfolio for 29% (AZN0.2B) and the mortgage portfolio for 6% (AZN0.04B) of the sectorial NPL portfolio. Whereas the NPL ratios stands at 4.1% on the business portfolio, this indicator is 3.4% and 1.2% on consumer and mortgage portfolios, respectively. In general, national currency denominated loans accounted for 76% and foreign currency denominated loans for 24% - of the NPL portfolio.

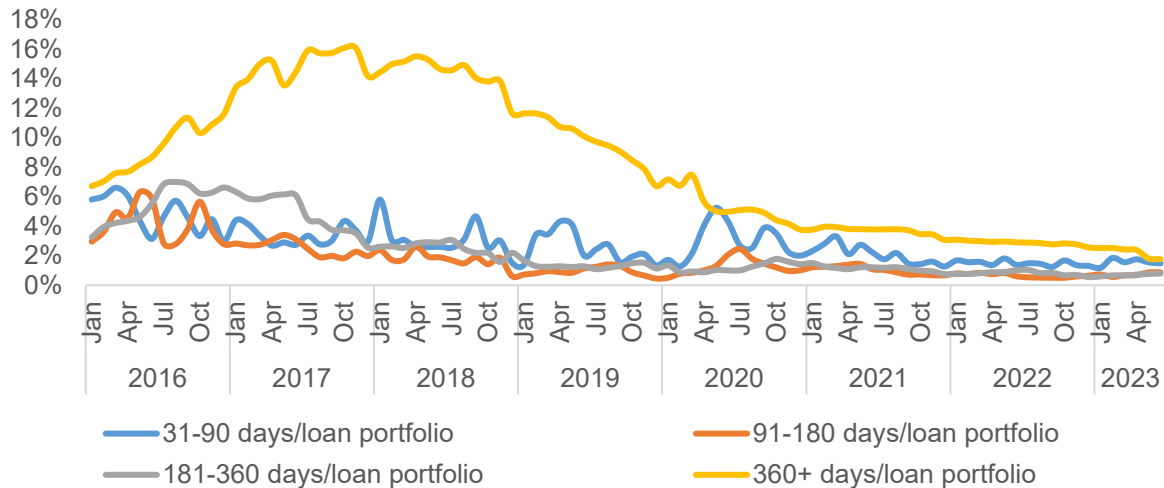
Chart 21. Sectorial and currency structure of the NPL portfolio



Source: CBA

The dynamics of the structure of the NPL portfolio on delinquency displays that the share of loans delinquent for over one year fell. On the backdrop of banking sector rehabilitation since 2017 the share of NPLs delinquent for over one year in the portfolio decreased by 12.4 pp and shifted to 1.8% from 14.2% (2.6% end-2022).

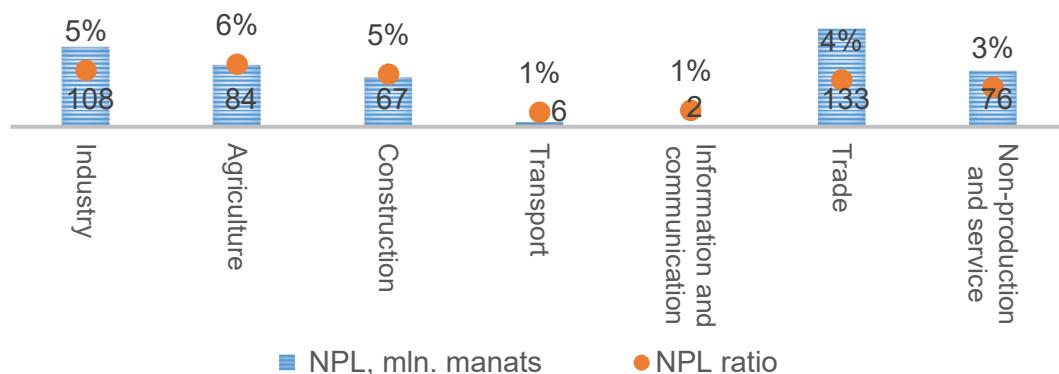
Chart 22. Breakdown of the lending portfolio on delinquencies



Source: CBA

NPLs decreased on the business portfolio. NPLs decreased by 6.3% to AZN475M. The NPL ratio on business loans decreased by 0.6 pp to 4.1%. The NPL portfolio is concentrated in trade and industry in terms of amount. 51% of total NPLs are issued to those sectors. The drop in NPLs over the period is attributable to the removal of the insolvent bank from the banking system.

Chart 23. The NPL portfolio structure across sectors of the economy



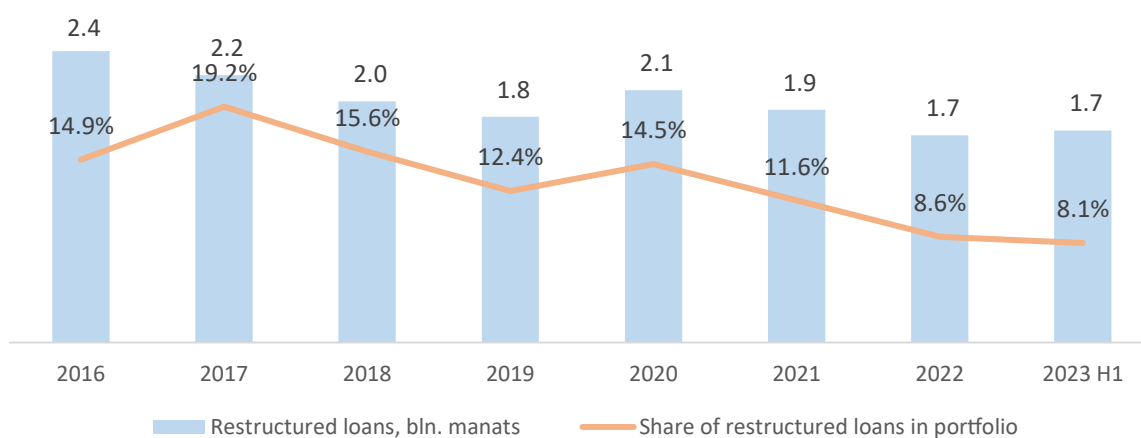
Source: CBA

Credit risks are kept on focus on the consumer portfolio. In H1 2023 NPLs on consumer loans increased by 16.1% (AZN30M) to AZN215M. 3.4% of the consumer portfolio is in the NPL status now, up by 0.2 pp compared with the beginning of the year. The prudential policy pursued by the Central Bank on consumer lending is oriented towards sound and responsible lending of the population and protection of the sector from potential threats.

NPLs in the mortgage lending decreased. In the first half of the year NPLs decreased by 6.3% (AZN3M) to AZN40M of the mortgage portfolio. As a result, the share of NPLs in the portfolio decreased by 0.2 pp to 1.2%. The NPL ratio issued from the resources of MCGF (57% or AZN1.9B of the mortgage portfolio) is merely 0.3%.

Introduction of a new prudential framework on the restructured portfolio had a downward effect on restructured portfolio risks. In H1 2023 the restructured portfolio increased by 2.3% (AZN39M) to AZN1.7B. Due to a high growth rate in the lending portfolio the share of restructured loans in the total portfolio decreased by 0.5 pp to 8.1%. Last year a new regulatory framework was elaborated on regulation of restructured portfolio risks. Strict provisioning requirements were determined on repeated restructuring of loans (attribution of assets to a riskier classification category at every next restructuring and the requirement for higher provisioning).

Chart 24. Dynamics of the restructured portfolio, billion AZN



Source: CBA

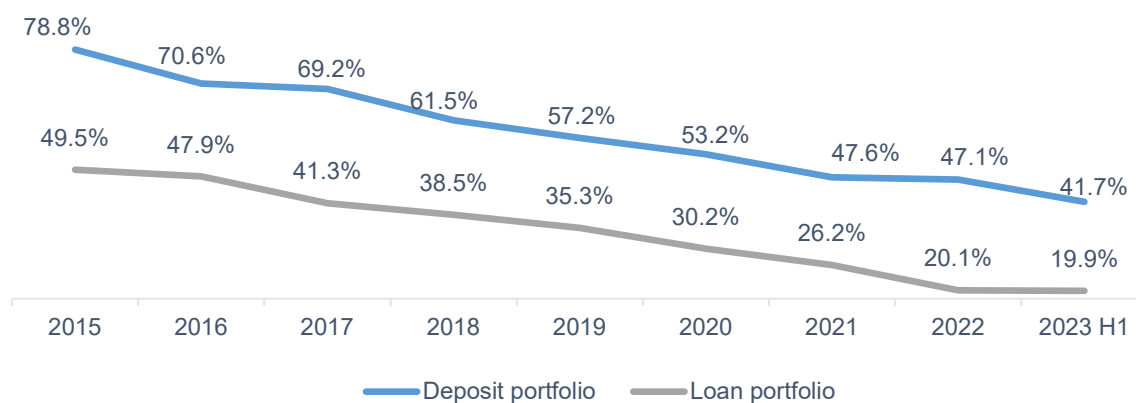
Market risk of the banking system

The currency position of the banking sector is within prudential requirements.

As of the end of the first half of 2023 the OCP of the banking system amounted to \$170M and the OCP to total regulatory capital ratio of the banking system was 5.3%. The safe zoning of the currency position is critical for safeguarding financial stability.

Long-term de-dollarization continues in the sector. Dollarization of the banking system's deposit portfolio decreased by 5.4 pp to 41.7%, while dollarization of the lending portfolio decreased by 0.2 pp to 19.9%.

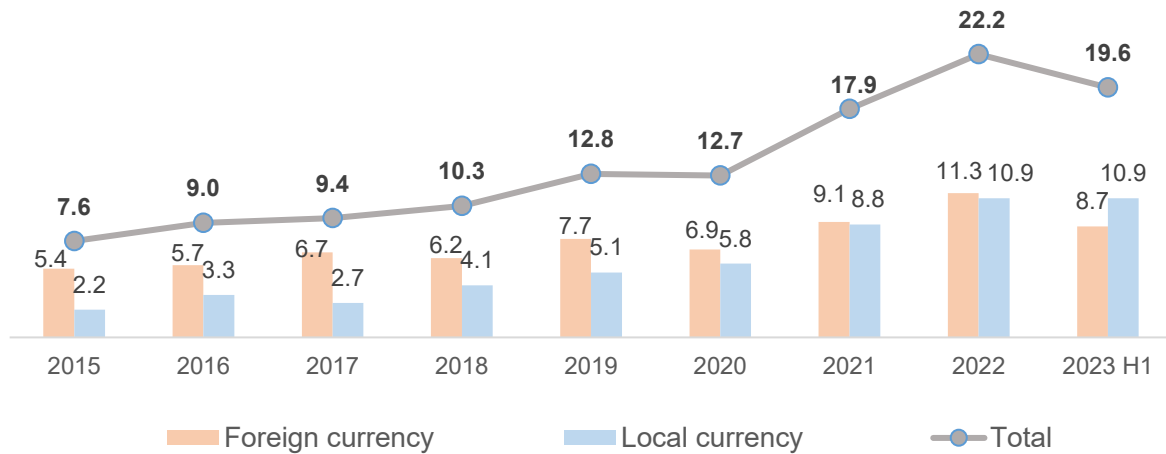
Chart 25. Dollarization of the deposit and loan portfolio



Source: CBA

De-dollarization of the deposit portfolio was driven by the drop in foreign currency denominated demand deposits of legal entities. Demand deposits of legal entities in foreign currency decreased by AZN3.1B, leading to 6.3 pp drop in dollarization of the deposit portfolio on legal entities to 44.6%. Long-term de-dollarization of term deposits of legal entities continued. Dollarization of term deposits of legal entities decreased by 2.4 pp to 67.7%.

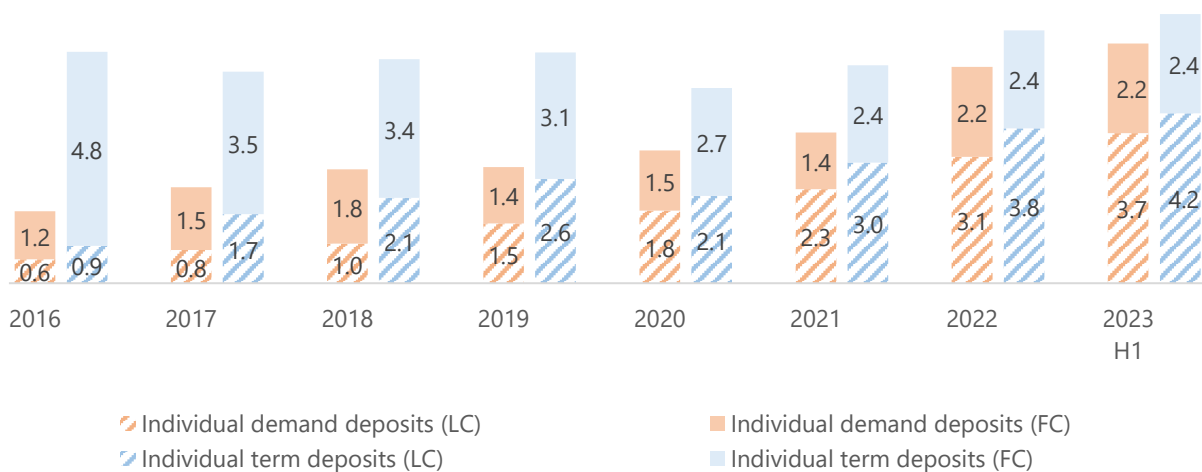
Chart 26. Currency breakdown of the deposit portfolio of legal entities, billion AZN



Source: CBA

The drop in dollarization of individuals continued. Over 6 months dollarization of total deposits of individuals decreased by 2.7 pp to 37.1%. The stability of the manat and high interest rates on national currency denominated deposits contribute to the rise in national currency denominated term deposits of individuals. Dollarization of term deposits decreased by 2.1 pp to 36.9%. Dollarization on foreign currency denominated demand deposits of individuals also decreased by 3.3 pp to 37.4% compared with the end of last year.

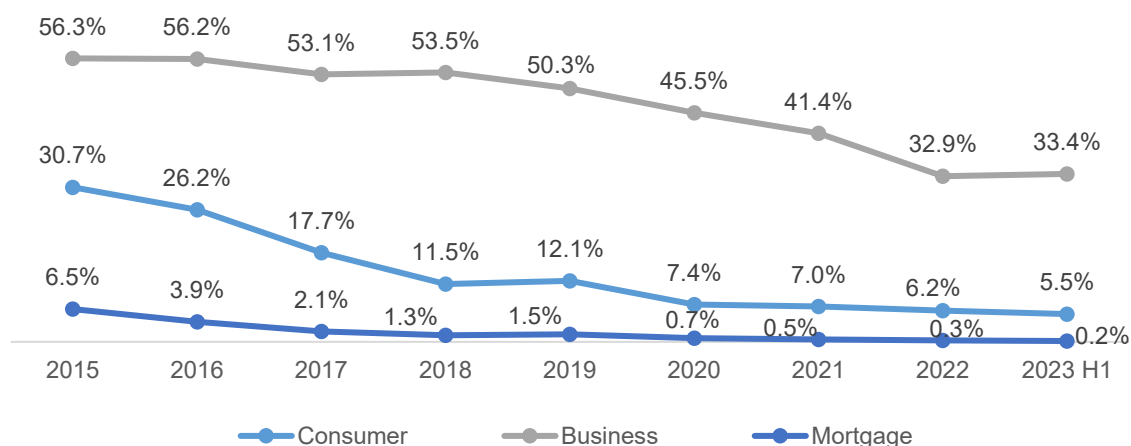
Chart 27. Currency structure of the deposit portfolio of individuals, billion AZN



Source: CBA

Dollarization of the lending portfolio is in lows. Dollarization of the lending portfolio decreased by 0.2 pp to 19.9% compared to the end of last year, driven by consumer loans. Dollarization on consumer loans decreased by 0.7 pp to 5.5%. At the same time, dollarization of mortgage loans decreased by 0.1 pp to 0.2%. Dollarization of the business portfolio increased by 0.5 pp to 33.4%. Restriction of the issue of foreign

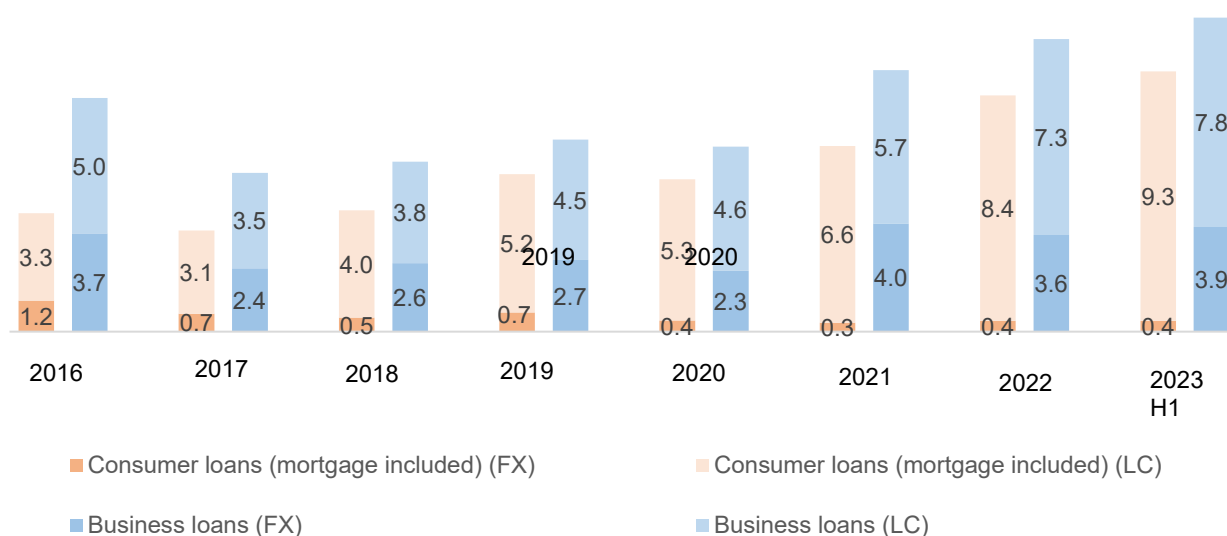
Chart 28. Dollarization of loan portfolio



Source: CBA

currency denominated consumer loans to borrowers with no foreign currency income and setting of additional risk weights on foreign currency loans contributed to the drop in consumer portfolio dollarization. Moreover, the requirement of regulations of the CBA to grant mortgage loans only in the national currency conditioned the portfolio of mortgage loans to be in national currency.

Chart 29. Currency structure and dynamics of the lending portfolio, billion AZN



Source: CBA

Since most assets and liabilities are recognized at their carrying value, calculations were made over the carrying value and discounted at the policy rate of the CBA. The main source of maturity mismatch between assets and liabilities is that the difference between average weighted duration of loans and attracted deposits is about 4 times.

Interest rate sensitivity of banks does not threaten their resilience. The interest rate risk was analyzed with the duration method¹. An increase in interest rates because of a positive duration difference has a downward effect on the CAR. According to simulations, a 1% rise in the interest rate decreases the CAR by only 0.9 pp that does not threaten the financial resilience of the banking system.

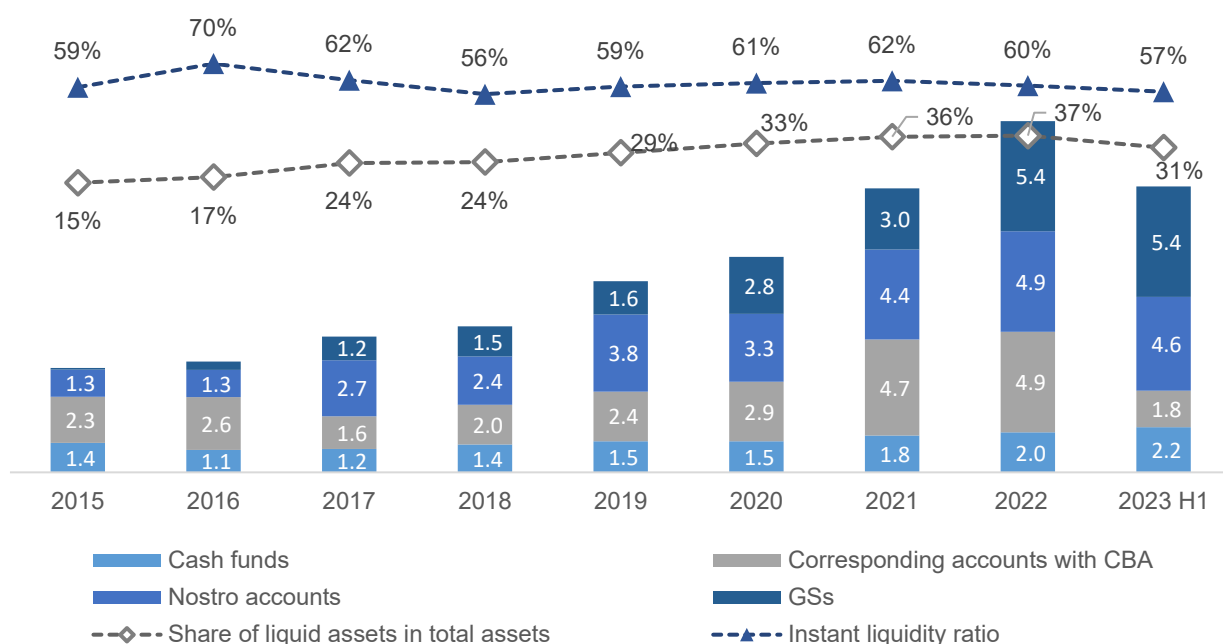
Liquidity risk of the banking system

Despite the drop in liquid assets, liquidity of the sector is in a comfort zone. Due to the decrease in demand deposits of legal entities, the size and share in total assets of liquid assets fell. Liquid assets decreased by 18.9% (AZN3.3B) to AZN14B. However, the instant liquidity ratio (the main prudential liquidity regulation norm) was 56.6%, about two times higher than the norm (30%). At the same time, liquid assets accounted for 30.9% of total assets, indicative to the fact that the sector has an adequate buffer against potential liquidity shocks.

Liquid assets are concentrated in GSs and nostro accounts. Concentration of liquid assets: GSs (39%), nostro accounts (33%), correspondent accounts with the CBA (13%), cash funds (16%). Liquid assets of the banking system exceed demand deposits of individuals by over 2.4 times and account for 87% of demand deposits of legal entities.

¹ The duration analysis is used for measuring the weighted average term of assets and liabilities according to Macaulay duration concept. To remind, the duration gap analysis measures the sensitivity of banks to market interest rates with the following formula: $\partial(\text{asset}) - \frac{\partial(\text{liability}) \times \text{liability}}{\text{asset}}$. During the analysis, assets and liabilities are discounted by the discount rate of the CBA.

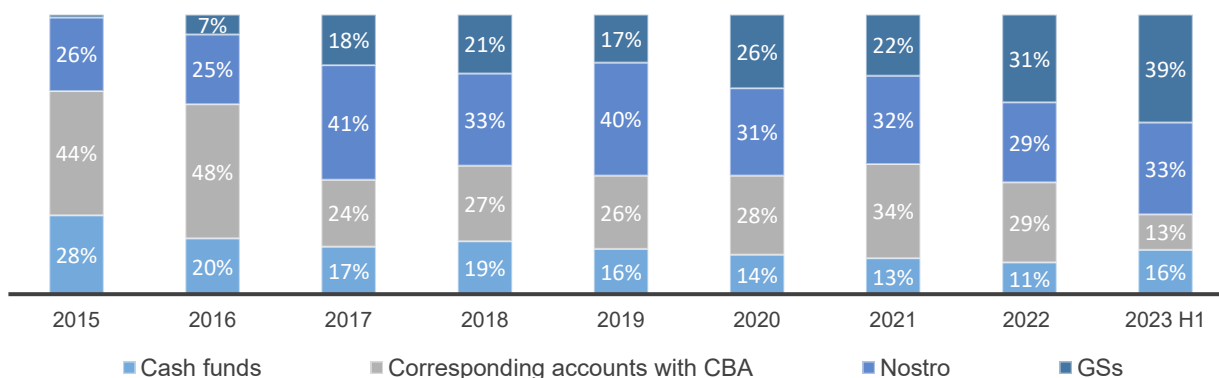
Chart 30. Dynamics of the structure of liquid assets, billion AZN



Source: CBA

The main drop on liquid asset components was on accounts with the CBA. Accounts of banks with the CBA decreased by AZN 3.1B to AZN1.8B compared with the end of last year. The revision of reserve requirements by the CBA stipulated the said change. To regulate money supply more effectively, elevate the effect of the interest rate corridor on interest rates in the financial system, contain the concentration of liquidity in the banking system and stimulate de-dollarization, the Management Board of the CBA with its Decision No 57/1 of 19.12.2022 decided to make changes to the 'Regulations on the ratio, calculation and maintaining required reserves'. According to the new Regulations, the reserve requirement has been increased both on individuals and legal entities, and national and foreign currency denominated deposits, which translated to the structure of liquidity in banks.

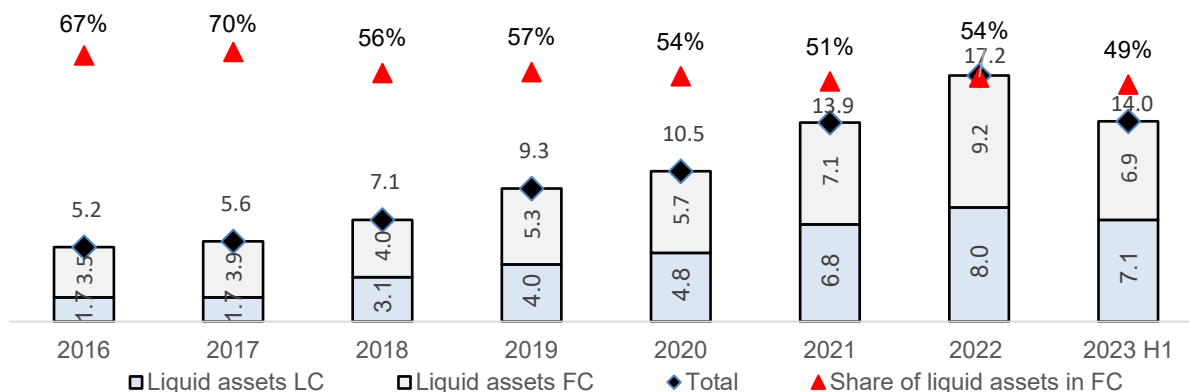
Chart 31. Dynamics of the share of liquid asset components



Source: CBA

Liquid assets in a foreign currency decreased in the share of liquid assets. Liquid assets in a foreign currency decreased by 25.6% (AZN2.4B) to AZN6.9B. Liquid assets of the sector in the national currency decreased by 11.1% (AZN0.9B) to AZN7.1B compared with the end of last year.

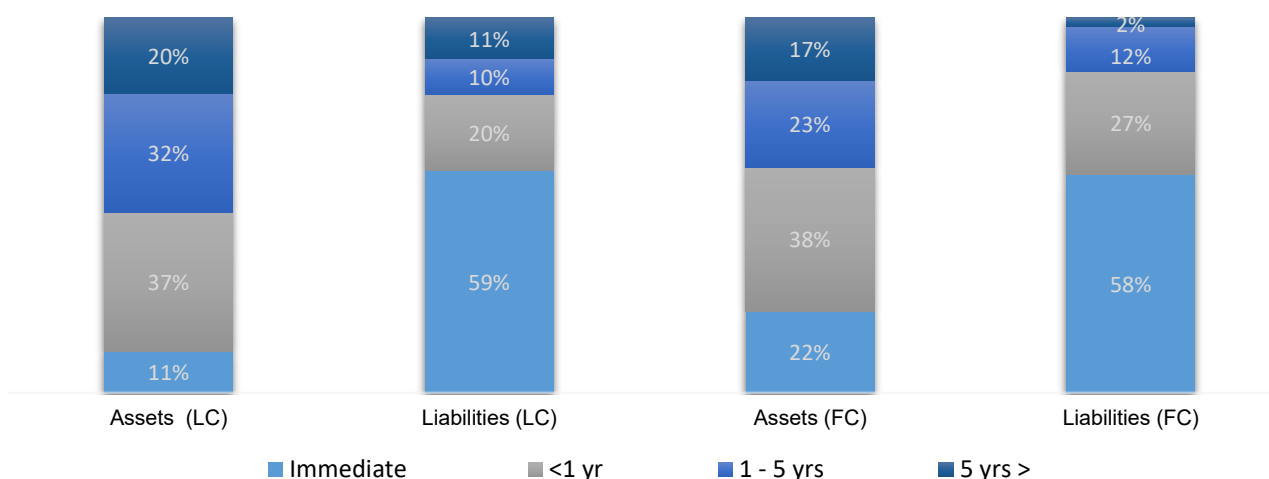
Chart 32. Dynamics of the currency structure of liquid assets, billion AZN



Source: CBA

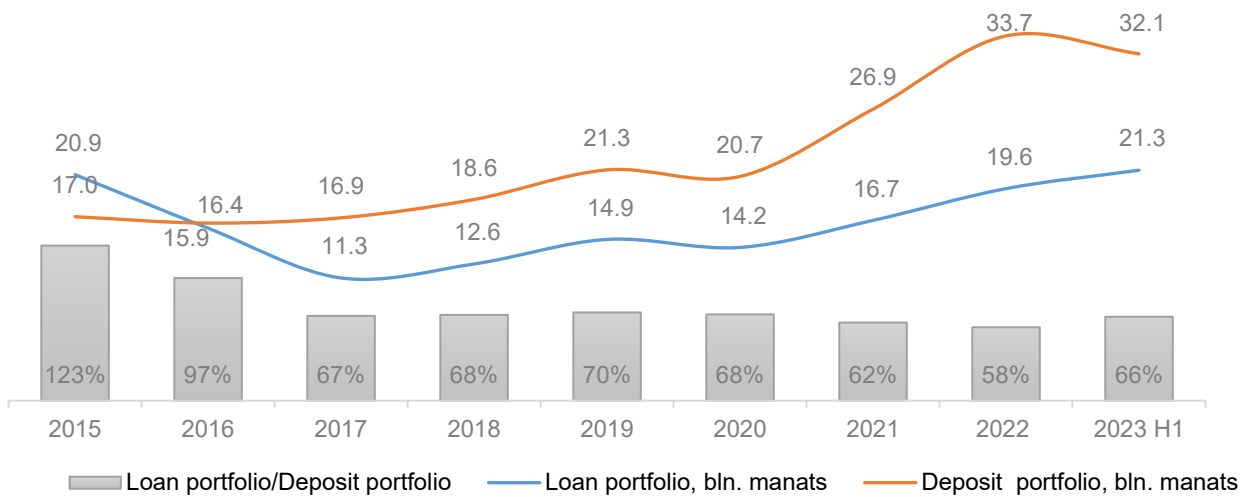
There is a maturity mismatch on assets and liabilities both in the national and foreign currencies. Whereas assets with up to one year maturity accounted for 48% of assets in the NC, the share of liabilities with up to one year maturity in total liabilities was 79%. The same is true for assets and liabilities in FC. Maturity of 65% of assets in FC and 85% of liabilities in FC is up to one year. While the rising share of current

Chart 33. Maturity structure of assets and liabilities



Source: CBA

Chart 34. Dynamics of loan to deposit ratio



Source: CBA

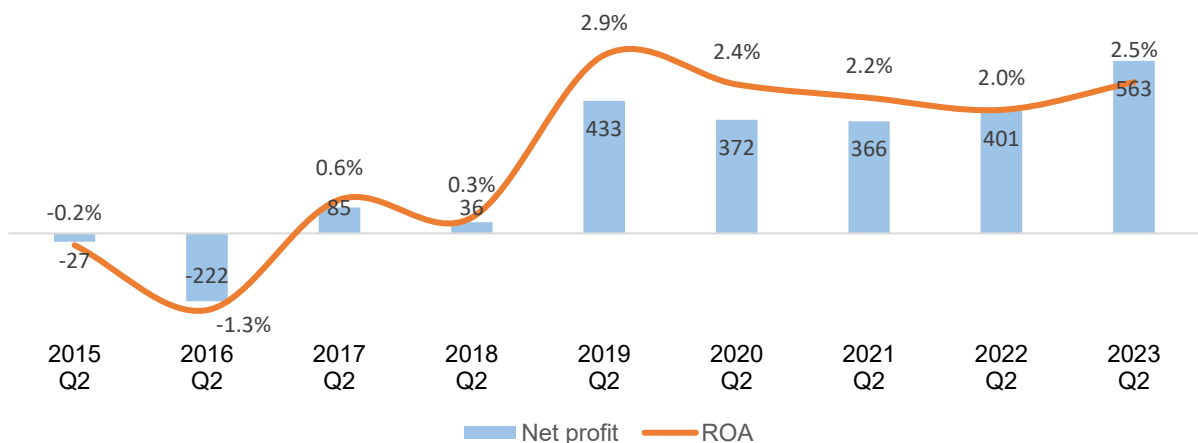
liabilities in the banking sector acts as the factor that contributes to maturity mismatch, the banks' liquidity buffer allows to avoid a grave effect of this mismatch on the system.

The credit to deposit ratio is growing. As of end-June 2023 the lending portfolio to the deposit portfolio ratio increased by 8.3 pp to 66%, driven by the expansion of the lending portfolio and decrease in demand deposits of legal entities.

Banking system profitability

Opportunities for profit generation of the sector are improving. In H1 2023 banking system net profitability amounted to AZN563M, yoy up by 40% (AZN162M). The ROA indicator is in post-pandemic highs.

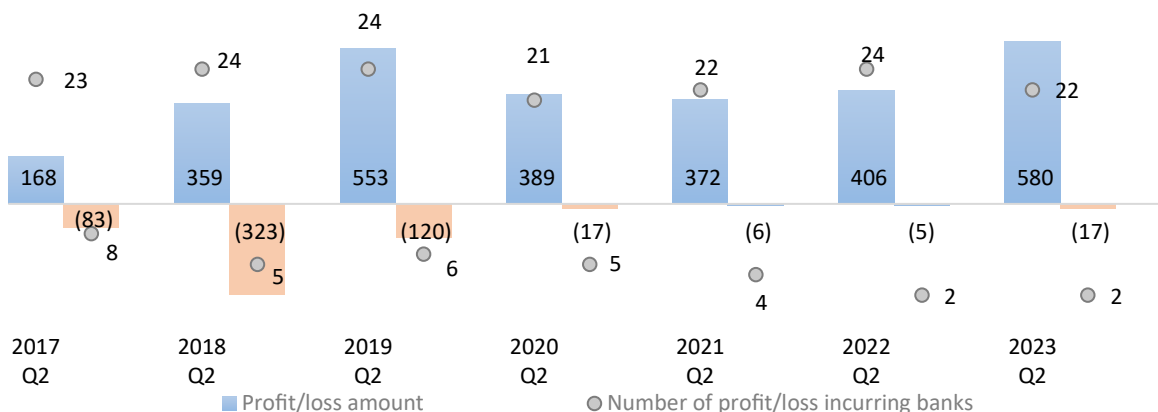
Chart 35. Banking system profitability, million AZN



Source: CBA

22 banks operated at a profit, while 2 operated at a loss in H1 2023. Profit of 22 banks operating at a profit amounted to AZN580M, while loss of 2 banks operating at a loss was AZN17M. In general, profitability indicators of the banking sector have been positive recent five years, both on a sector, and an individual bank level.

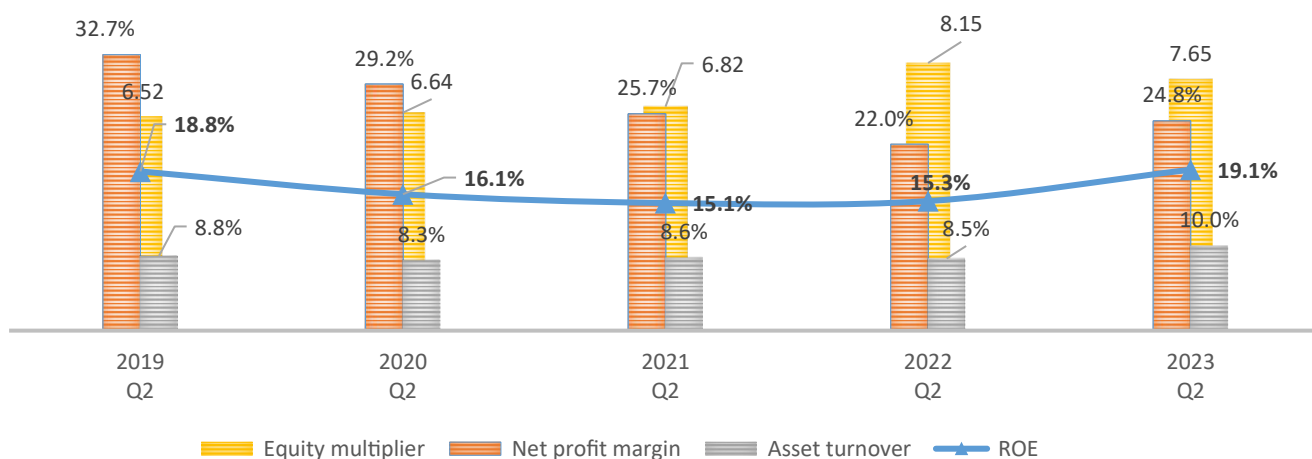
Chart 36. The number and dynamics of banks operating at a profit and loss, billion AZN



Source: CBA

Profitability of banks was driven by profit margin and the rise in asset turnover. ROE yoy increased by 3.8 pp to 19.1%. The DuPont analysis, widely used in international practice to analyze profitability components² has identified that banks'

Chart 37. Decomposition of ROE



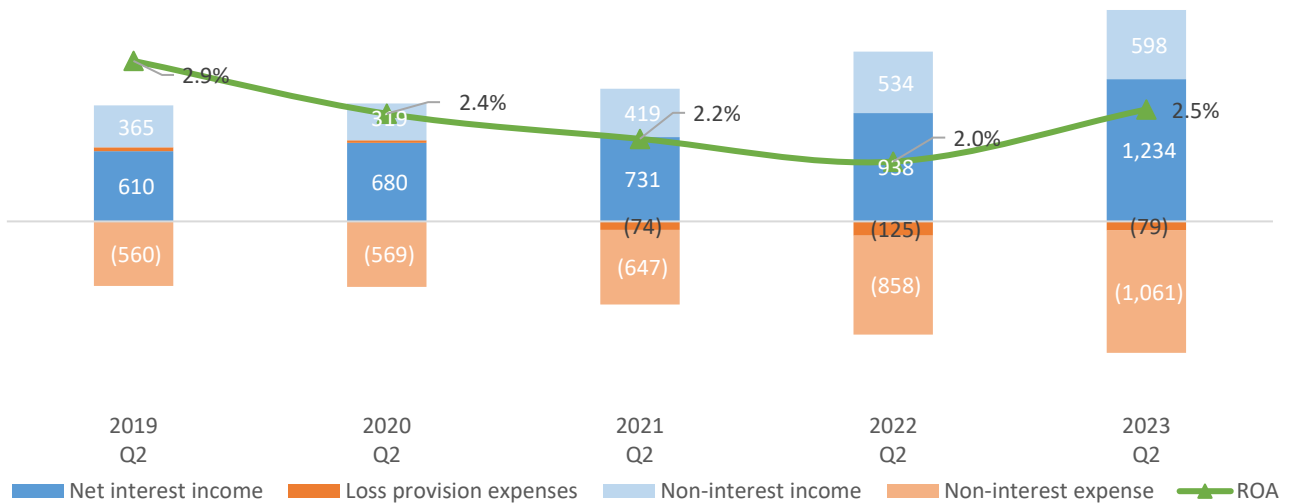
Source: CBA

² The DuPont analysis decomposes the ROE into various components and analyzes sources of profitability. In widely used international practice ROE equals to the sum of profit margin (net profit / total income), asset turnover (total income / assets) and the leverage ratio. For the purposes of the Dupont analysis, the said indicators were calculated on and averaging basis, but in accordance with the relevant reporting date.

higher profit margin and operation with asset turnover contributed to ROE growth over recent six months. The reduction in assets decreased the leverage ratio. The asset turnover increased by 1.5 pp to 10% due to the drop in assets and the rise in total income. Positive dynamics in net profit of the sector and a higher growth rate compared with current income contributed to the rise in profit margin. Net profit margin yoy increased by 2.8 pp to 24.8%.

Net profit growth was driven by net interest income. Net interest income yoy increased by AZN296M (32%), the main factor that stipulates nominal profitability of the banking sector. Moreover, AZN46M (37%) worth drop in specific reserves, at the same time, AZN64M (12%) rise in non-interest income contributed to profit margin growth. Non-interest expenses yoy increased by 24% (AZN203M).

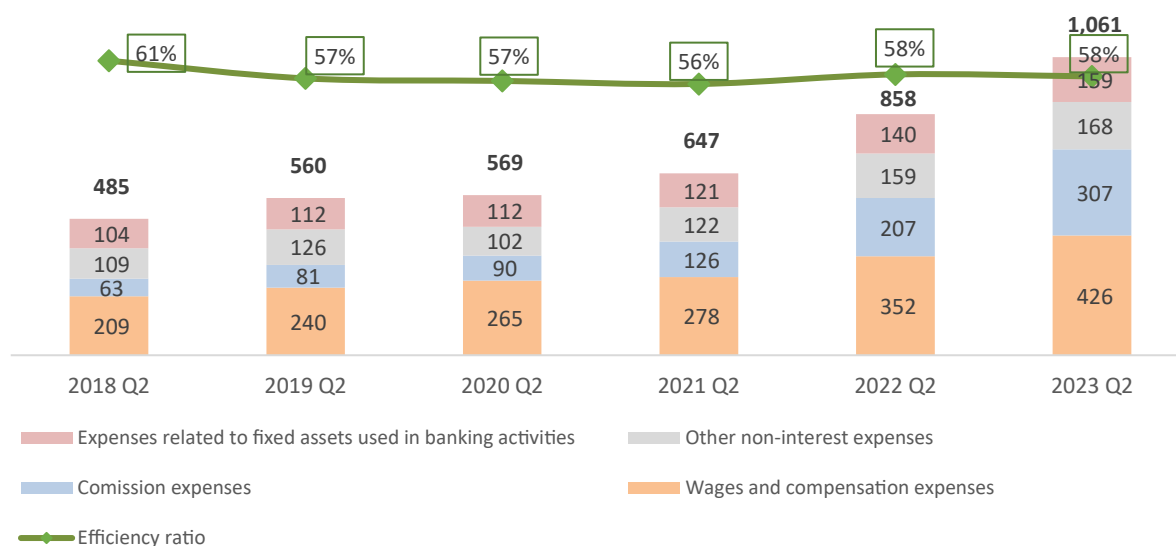
Chart 38. Decomposition and dynamics of profit across the sector



Source: CBA

While banks' non-interest expenses increased, efficiency of the sector remained stable amid rising interest and non-interest income. Although non-interest expenses of the sector increased at the expense of salaries and other types of compensation, and fees and commissioning expenses on services supplied, the non-interest expenses to total income ratio, the key efficiency indicator³ remained stable year over year. The non-interest expenses to total income ratio stood at 58%.

Chart 39. The structure of non-interest expenses and the efficiency ratio

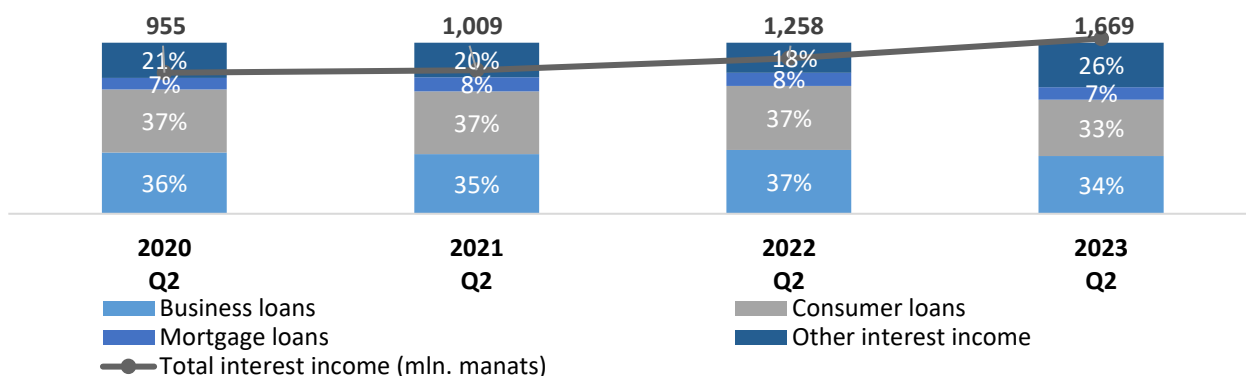


Source: CBA

Banks earn interest income from consumer and business loans. In Half1 2023 net interest income of the sector increased by 33% (AZN411M), while net interest expenses increased by 36% (AZN108M) to AZN1.7B and AZN405M, respectively. The main portion of interest income was earned on consumer (AZN562M) and business (AZN551M) loans last year. Significant year over year growth was in other interest income (91% or AZN227M) generated from deposits with banks (AZN87M), securities (AZN71M) and interest bearing nostro accounts (AZN47M).

³ According to the IMF FSI methodology, the efficiency ratio is calculated as the ratio of non-interest expenses to the sum of net interest and non-interest income (net profit).

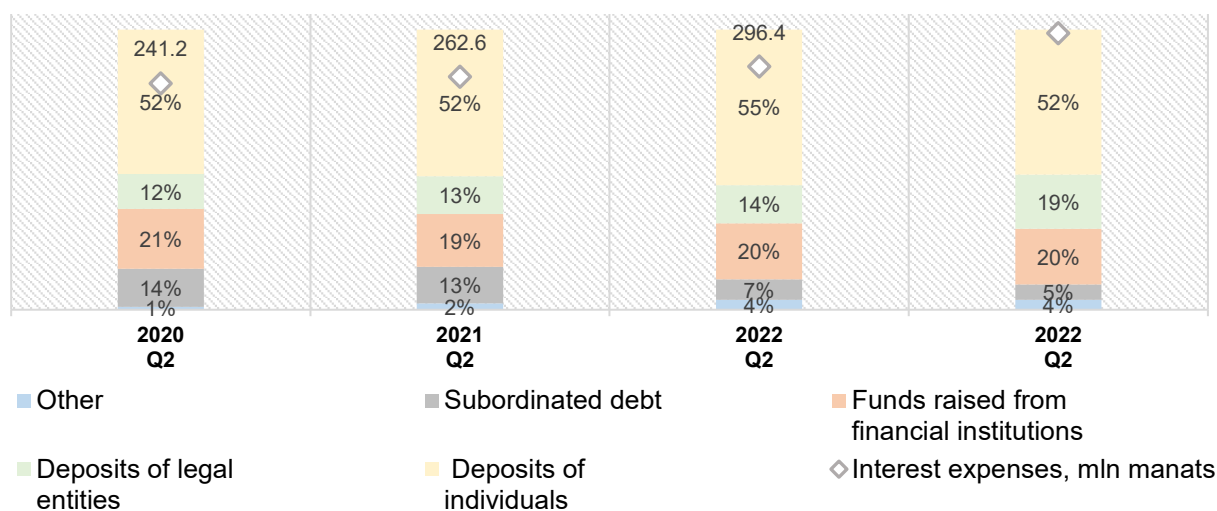
Chart 40. Structure of interest income, million AZN



Source: CBA

The main part of interest expenses of banks is expenses on deposits of individuals. Deposits of individuals, banks' sustainable funding source, take a huge part of interest expenses of banks as well (52% or AZN210M). Other main items of interest expenses are deposits of legal entities and loans of financial institutions.

Chart 41. The structure of interest expenses

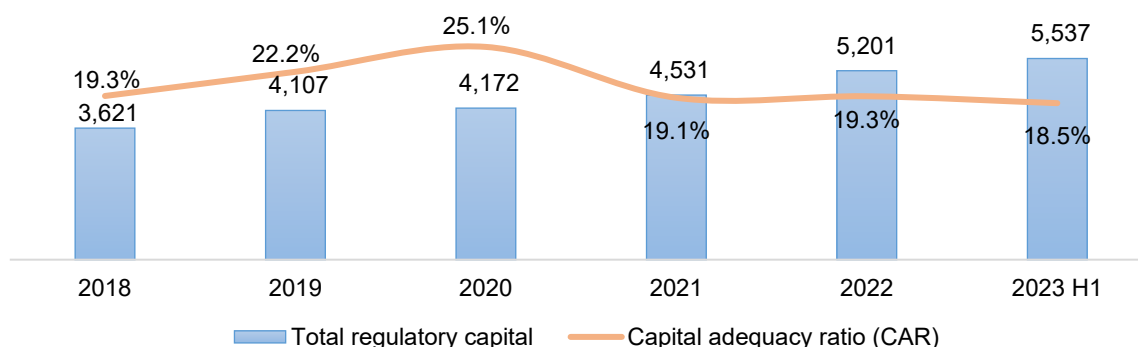


Source: CBA

Capital position of the banking system

The capital position of the sector is capable to absorb potential losses exceeding prudential norms. Over 6 months of 2023 total regulatory capital of the banking sector increased by 6.5% (AZN336M) to AZN5.5B. While the CAR of the sector decreased by 0.8 pp to 18.5%, due to faster increase in RWAs over the period.

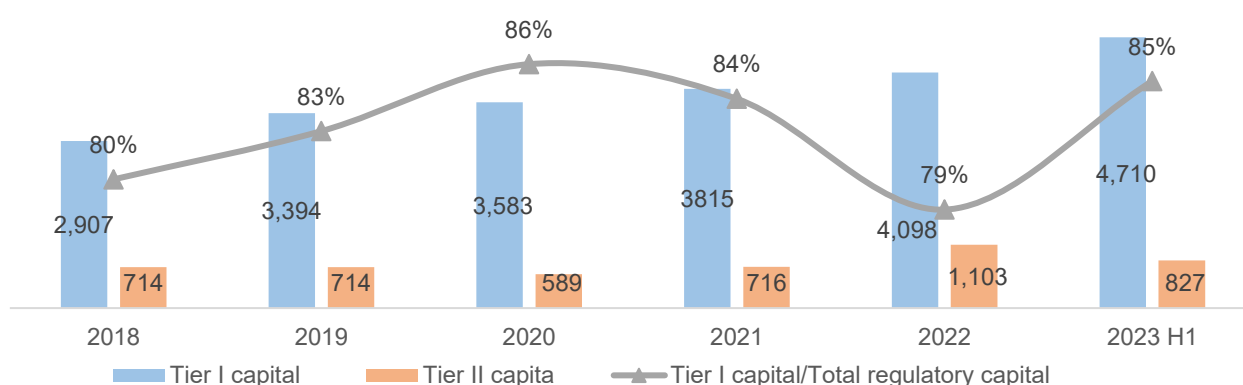
Chart 42. Dynamics of capital adequacy, million AZN



Source: CBA

The main driver of total regulatory capital growth was Tier I capital growth. Tier I capital increased by 14.9% (AZN612M) to AZN4.7B, due to banks' internal profit generation. High-quality Tier I capital increased due to channeling of retained earnings of the previous year to net profit. At the same time, one bank made AZN55M worth capital injection. The decrease in Tier II capital relates to the fact that that it is less compared to the end of last year since profit of last year was channeled to Tier I capital and profit of current year is cumulative.

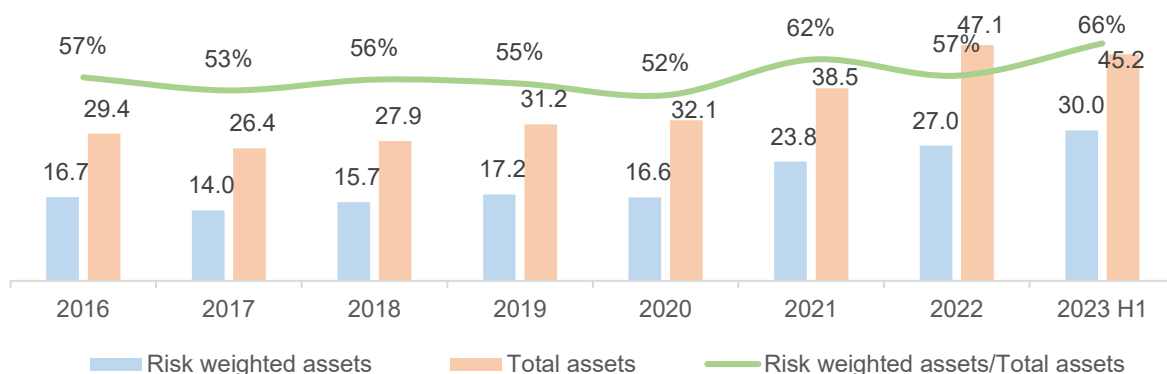
Chart 43. Dynamics of the capital structure, million AZN



Source: CBA

RWAs increased over first six months of the year. On the backdrop of 4% (AZN1.8B) worth decrease in total assets RWAs increased by 11.2% (AZN3B). Consequently, the RWAs to total assets ratio increased by 9 pp to 66%. Prudential tightening since 2021 with the increase of RWA requirements on consumer loans, considered riskier, and inclusion of operational and market risks to RWA calculations, raised RWAs, the growth rate of assets was higher over the year. Credit risks accounted for major part of RWAs (90%).

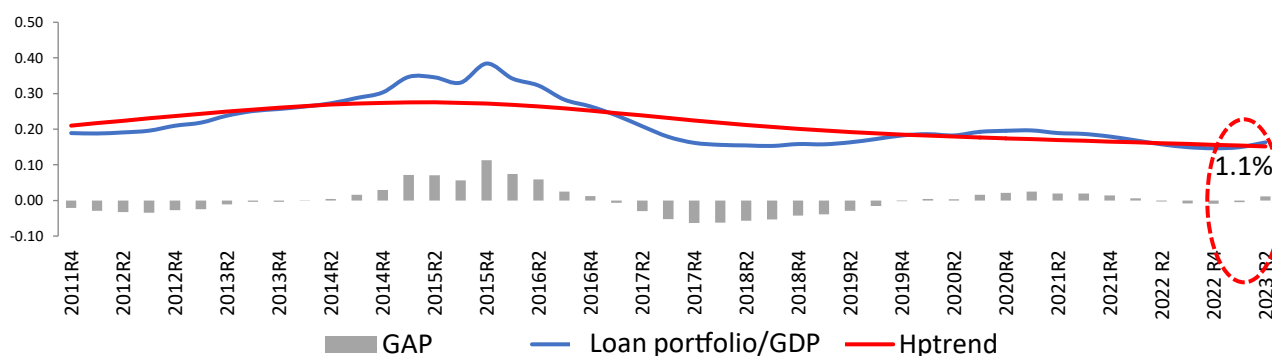
Chart 44. Dynamics of assets and RWAs, billion AZN



Source: CBA

Consideration of the Basel III based counter-cyclic capital buffer. According to the ‘Regulations on calculation of bank capital and its adequacy,’ the CBA may impose a 0 -2.5% counter-cyclic capital buffer to Tier I capital and the aggregate CAR in line with the economic cycle and the dynamics of the lending portfolio. As a macro prudential tool, a counter-cyclic capital buffer implies prevention of systemic risks resulting from excess lending in the banking sector and reduction of sensitivity to cyclic developments. A credit gap⁴ is used as the main indicator for calculation of the counter-cyclic capital buffer. When the capital gap ranges between 2-10%, the counter-cyclic capital buffer is set at 0-2.5%. At present, the credit gap is 1.1%.

Chart 45. The loan portfolio to GDP ratio, HP trend, in percentage



Source: CBA

⁴ Credit gap – is the difference between the ratio of the loan portfolio to customers by banks to GDP in the relevant period and the indicator of the long-term trend of this ratio for that period.

Table 2. Selected main banking system indicators*, million AZN

| | 2023 Q2 | 2023 Q1 | 2022 Q4 | 2022 Q3 | 2022 Q2 | 2022 Q1 |
|---------------------------------|------------|------------|------------|------------|------------|------------|
| Balance sheet indicators | | | | | | |
| Total assets | 45,218 | 44,843 | 47,055 | 43,633 | 41,920 | 39,673 |
| Liquid assets | 13,985 | 14,249 | 17,242 | 13,865 | 15,669 | 14,925 |
| Lending portfolio | 21,296 | 20,039 | 19,594 | 19,157 | 18,320 | 17,528 |
| Business loans | 11,651 | 10,971 | 10,855 | 10,781 | 10,482 | 10,182 |
| Consumer loans | 6,325 | 5,942 | 5,754 | 5,602 | 5,190 | 4,831 |
| Mortgage loans | 3,321 | 3,125 | 2,985 | 2,775 | 2,649 | 2,515 |
| Total liabilities | 39,306 | 38,994 | 41,433 | 38,288 | 36,774 | 34,732 |
| Current liabilities | 25,375 | 25,447 | 27,048 | 24,438 | 24,346 | 22,831 |
| Deposits of individuals | 12,473 | 11,719 | 11,483 | 10,993 | 10,379 | 10,201 |
| Term deposits of individuals | 6,596 | 6,311 | 6,204 | 5,964 | 5,736 | 5,502 |
| Demand deposits of ind. | 5,877 | 5,408 | 5,279 | 5,029 | 4,642 | 4,699 |
| Deposits of legal entities | 19,584 | 20,214 | 22,280 | 20,381 | 19,603 | 18,058 |
| Term deposits of LEs | 3,478 | 2,894 | 2,578 | 2,388 | 2,251 | 1,934 |
| Demand deposits of LEs | 16,106 | 17,320 | 19,702 | 17,992 | 17,353 | 16,124 |
| Equity | 5,913 | 5,849 | 5,622 | 5,345 | 5,146 | 4,942 |
| Capital position | | | | | | |
| Tier I capital | 4,710 | 4,935 | 4,098 | 4,097 | 4,229 | 4,265 |
| Total regulatory capital | 5,537 | 5,420 | 5,201 | 4,967 | 4,790 | 4,528 |
| RWAs | 29,995 | 28,505 | 26,977 | 26,980 | 26,346 | 25,003 |
| Tier I capital adequacy | 15.7% | 17.3% | 15.2% | 15.2% | 16.1% | 17.1% |
| Regulatory capital adequacy | 18.5% | 19.0% | 19.3% | 18.4% | 18.2% | 18.1% |

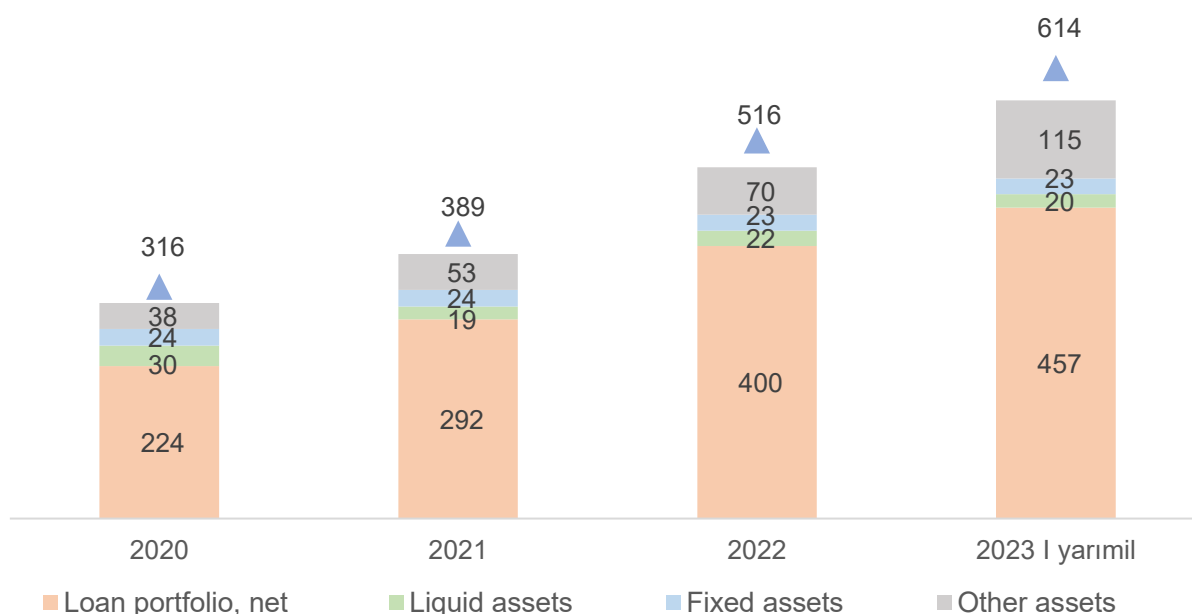
| | 2023 Q2 | 2023 Q1 | 2022 Q4 | 2022 Q3 | 2022 Q2 | 2022 Q1 |
|---|------------|------------|------------|------------|------------|------------|
| Profitability | | | | | | |
| Net profit | 563 | 268 | 914 | 683 | 401 | 174 |
| ROA | 2.5% | 2.3% | 2.2% | 2.2% | 2.0% | 1.8% |
| ROE | 21.3% | 20.3% | 18.9% | 19.2% | 17.1% | 15.0% |
| Liquidity risk profile | | | | | | |
| Liquid assets | 13,985 | 14,249 | 17,242 | 13,865 | 15,669 | 14,925 |
| Share of liquid assets in assets | 30.9% | 31.8% | 36.6% | 31.8% | 37.4% | 37.6% |
| Instant liquidity ratio | 56.6% | 54.8% | 59.9% | 55.5% | 61.4% | 64.0% |
| Credit risk profile | | | | | | |
| NPLs | 730 | 750 | 735 | 786 | 827 | 812 |
| Business loans | 475 | 506 | 507 | 526 | 552 | 558 |
| Consumer loans | 215 | 198 | 185 | 210 | 222 | 192 |
| Mortgage loans | 40 | 45 | 43 | 51 | 53 | 62 |
| NPL ratio | 3.4% | 3.7% | 3.8% | 4.1% | 4.5% | 4.6% |
| Business loans | 4.1% | 4.6% | 4.7% | 4.9% | 5.3% | 5.5% |
| Consumer loans | 3.4% | 3.3% | 3.2% | 3.8% | 4.3% | 4.0% |
| Mortgage loans | 1.2% | 1.5% | 1.4% | 1.8% | 2.0% | 2.5% |
| Market risk profile | | | | | | |
| Asset dollarization | 35.9% | 37.6% | 40.5% | 40.8% | 40.0% | 39.9% |
| Liability dollarization | 40.0% | 42.2% | 45.0% | 45.0% | 45.7% | 46.5% |
| * Prudential reporting methodology based. | | | | | | |

Non-bank credit institutions

The role of non-bank credit institutions (NBCIs) is still small in financial intermediation. The market share of NBCIs in the financial system was 1.3% in terms of assets⁵. Licenses of 3 NBCIs were revoked, thus, the number of operating NBCIs dropped to 92. 15 NBCIs are operating with foreign capital, in 12 out of them the share of foreign capital is over 50%. NBCIs numbered 52 and credit unions (CUs) numbered 40. Over the period the number of employees of NBCIs increased by 205 persons to 3064 persons, the number of branches decreased to 280 from 287. No new license was issued over the reporting period.

The balance of NBCIs expanded in H1 2023. Total assets of NBCIs increased by 19% (AZN99M) to AZN614M. Increased assets are channeled to the expansion of the net lending portfolio (up by 14% (AZN57M)).

Chart 46. Dynamics of assets of NBCIs, million AZN

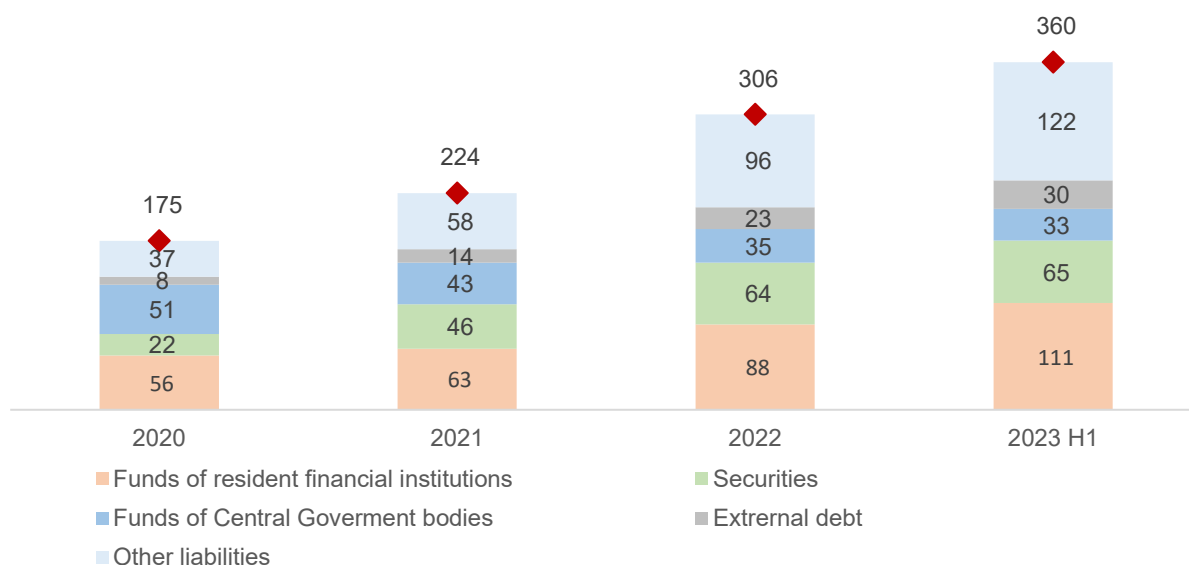


Source: CBA

Asset growth was driven by the growth of liabilities of NBCIs due to the financial system. Total liabilities of NBCIs increased by 17.7% (AZN54M) to AZN360M, owing to loans of banks and other financial institutions (AZN29M).

⁵ The 'Agrarcredit' CJSC was skipped in the analysis of NBCIs.

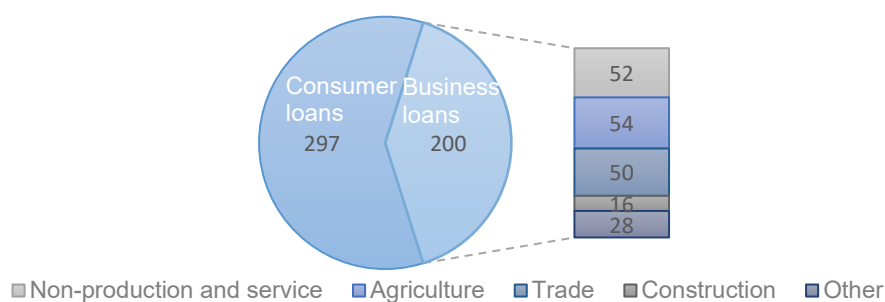
Chart 47. Dynamics of liabilities of NBCIs, million AZN



Source: CBA

The lending portfolio expanded at the expense of both business and consumer loans – it increased by 12.7% (AZN56M) to AZN497M. 6-month growth stood at 12.5% on consumer and 13% on business loans. As of end of H1 2023 NBCIs' lending portfolio included consumer (60%, AZN297M) and business loans (40%, AZN200M). Agriculture loans accounted for 27% (AZN54M), non-production and service areas for 26% (AZN52M) and trade loans for 25% (AZN50M) of the business portfolio.

Chart 48. The lending portfolio structure of NBCIs, million AZN

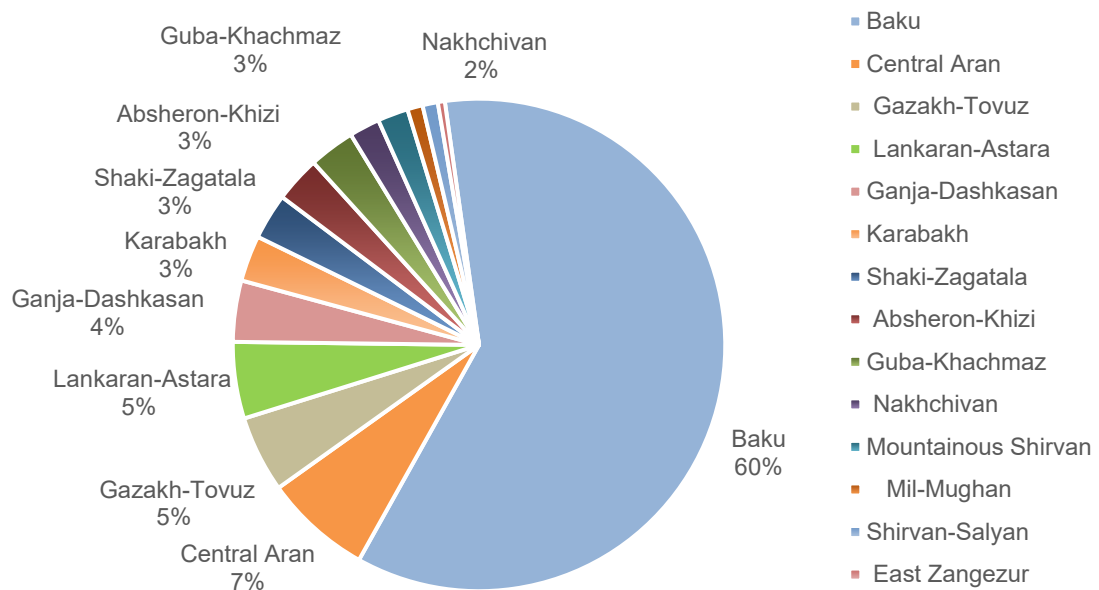


Source: CBA

The NPL ratio on the lending portfolio improved on the backdrop of portfolio growth. The NPL portfolio of the sector increased by 4% to AZN69.2M. Nevertheless, the NPL ratio of the sector decreased by 1.2 pp to 13.9% amid fast lending portfolio growth.

Signs of concentration continues in the NBCI sector. There are only 18 NBCIs in the sector whose assets are higher than AZN10M (81% (AZN500M) of total assets of NBCIs. Moreover, there is considerable concentration across regions. 60% of loans issued across the sector is concentrated in Baku.

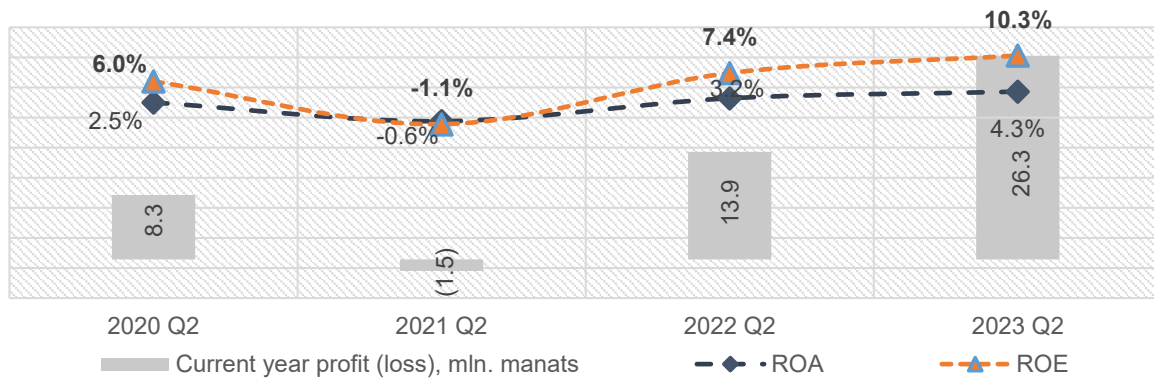
Chart 49. Lending portfolio distribution across economic regions



Source: CBA

The sector continues generating profit. In H1 2023 NBCIs earned AZN26.3M worth profit, yoy up by over 1.9 times. Profitability growth of the sector was also driven by higher operational efficiency of credit institutions, in addition to the lending portfolio growth and rising interest income. ROA and ROE of the sector yoy increased by 4.3% and 10.3% respectively.

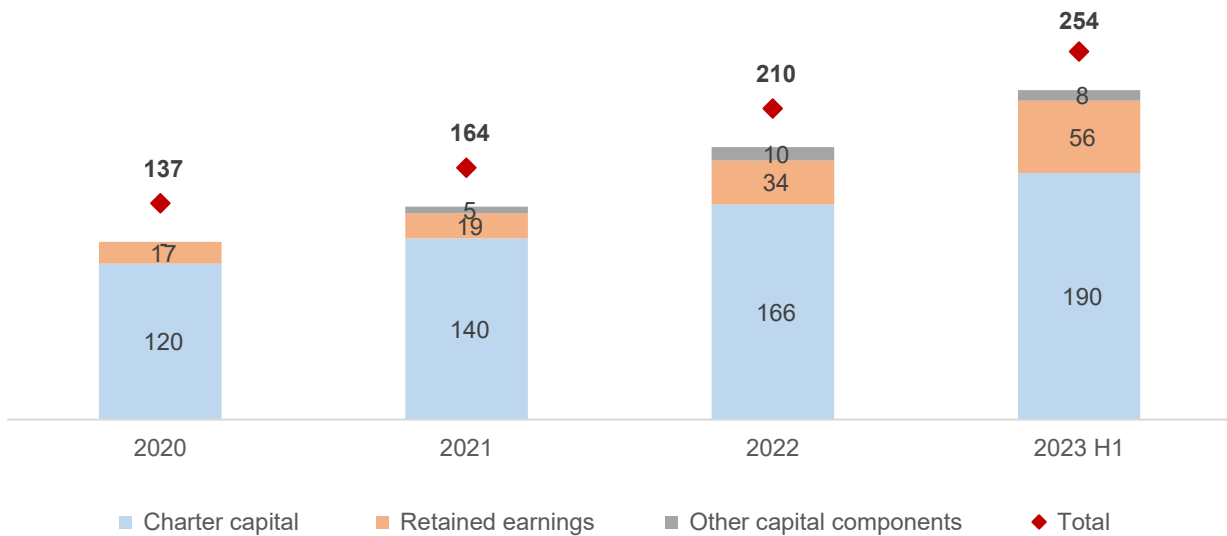
Chart 50. Dynamics of NBCI sector profitability, million AZN



Source: CBA

The capital position of the sector is following a positive tendency. Capital of NBCIs increased by 21% (AZN44M) to AZN254M. Capital growth was driven by both capital injection and profit generation of NBCIs.

Chart 51. Dynamics of capital components on the NBCI sector, million AZN



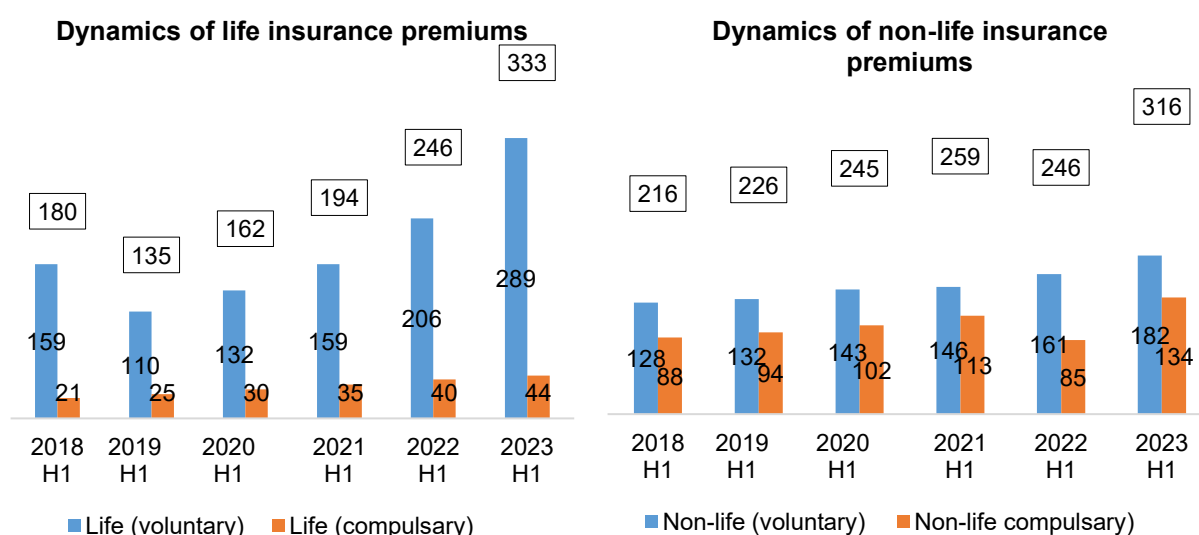
Source: CBA

Insurance sector

As of end of the first half of 2023, there were 19 insurance companies and one reinsurance company in the Azerbaijani insurance market, out of which 5 are life and 14 non-life insurance companies. 29 insurance brokers and 607 insurance agents contributed to the insurance sector.

Insurance premiums increased yoy by 32% (AZN157M) to AZN649M. Voluntary insurance types increased in terms of amount (up by 28% (AZN104M)). Types of compulsory insurance increased by 43% (AZN53M). Growth of voluntary insurance was driven by endowment life insurance. The endowment life insurance accounted for AZN82M of total AZN104M growth. In general, the size of insurance premiums collected over recent 5 years increased by 80% (AZN288M). The insurance premium on life insurance classes increased by 147% (AZN198M), while on non-life insurance classes it increased by 40% (AZN90M).

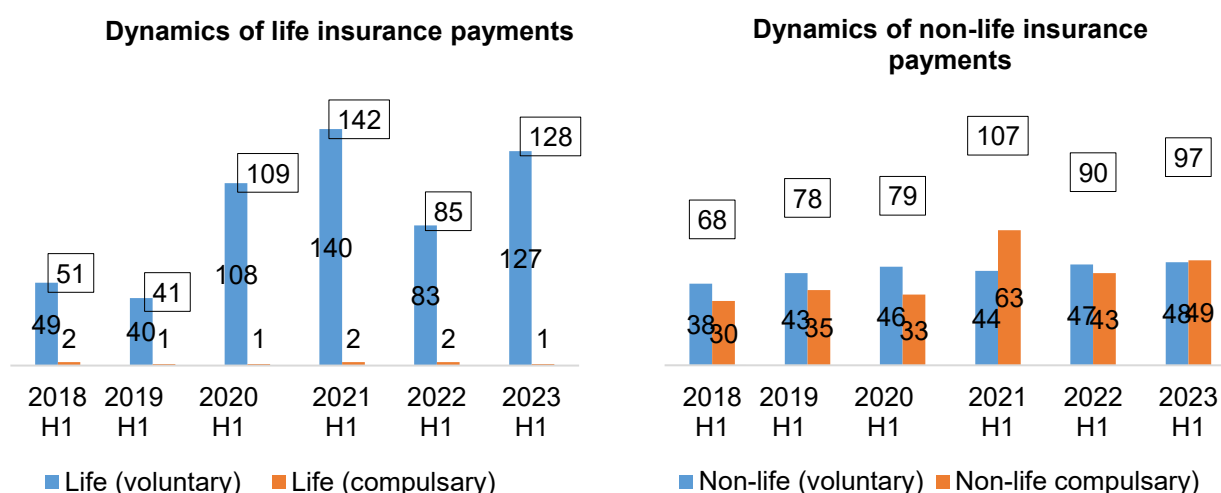
Chart 52. Dynamics of insurance premiums, million AZN



Source: CBA

Insurance payments increased yoy by 29% (AZN50M) to AZN225M, driven by the endowment life insurance. Over six months endowment life insurance payments increased by 56% (AZN45M) to AZN127M. Payments on non-life insurance classes increased by 7% (AZN6M) to AZN97M.

Chart 53. Dynamics of insurance payments, million AZN

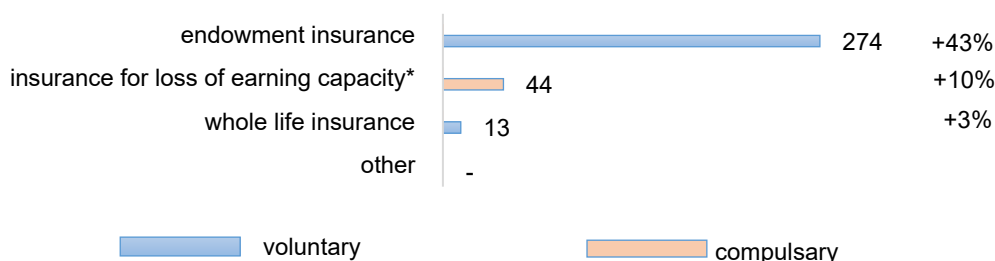


Source: CBA

- **Structure of collected fees across insurance classes:**

The endowment life insurance is the locomotive of life insurance classes (AZN274M, 82% of total life insurance premiums). Namely this insurance type increased compared with June 2022 (43% or AZN82M).

Chart 54. Structure of life insurance premiums across classes, million AZN

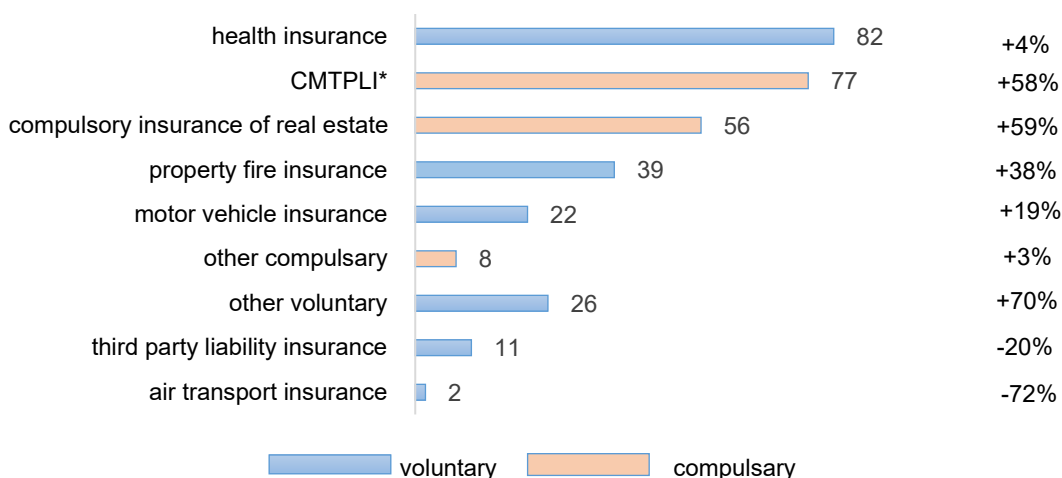


* Compulsory insurance against industrial accidents and occupational diseases

Source: CBA

Medical insurance (AZN82M, 25% of non-life insurance payments), compulsory civil liability insurance for motor vehicle owners (CCLIMVO) (AZN77M, 24% of non-life insurance payments) and compulsory real estate insurance (AZN56M, 17% of non-life insurance payments) accounted for the main part of non-life insurance payments. The highest growth in payments was in CCLIMVO (AZN28M, 58%) and compulsory real estate insurance (59%, AZN21M).

Chart 55. Structure of non-life insurance premiums across classes, million AZN

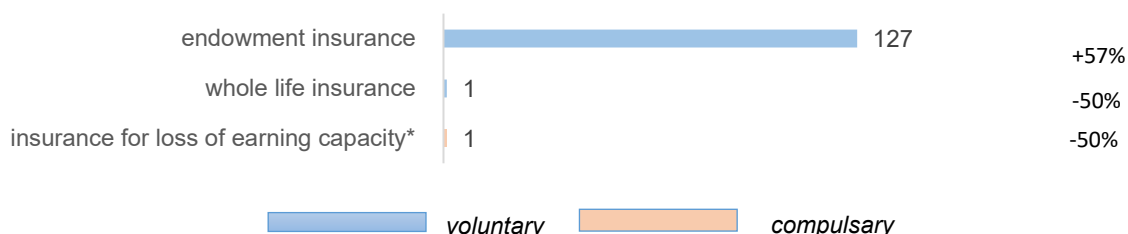


Source: CBA

- Structure of payments across insurance classes

Endowment life insurance acts as the main class in the structure of payments across life insurance classes. Endowment life insurance payments yoy increased by 57%. This insurance class accounted for 98% (AZN129M) on total life insurance payments.

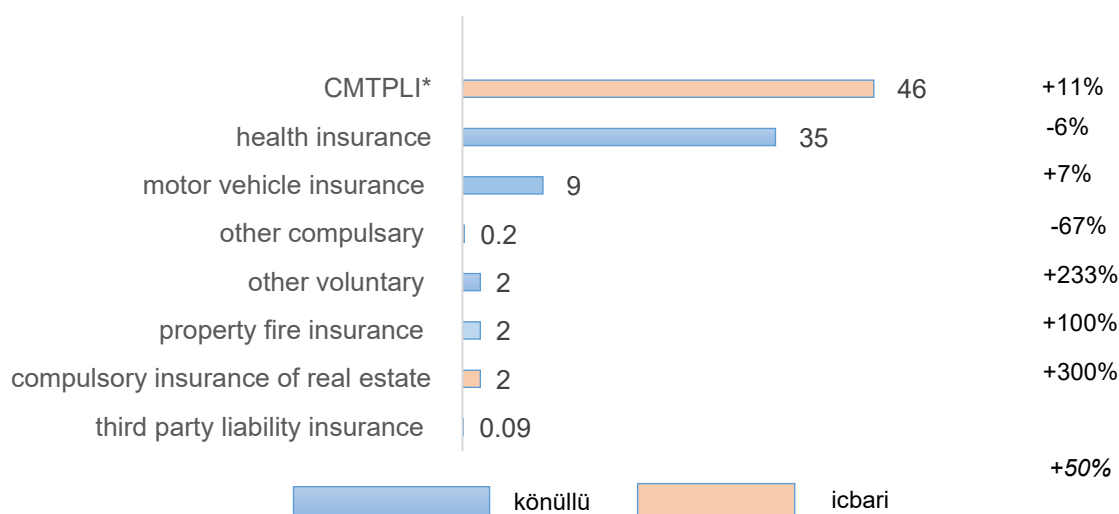
Chart 56. Structure of life insurance payments across classes, million AZN



Source: CBA

The highest growth in payments on non-life insurance classes was in CCLIMVO (AZN46M, 48.2% of non-life insurance payments), compulsory medical insurance (AZN35M, 36.4% of non-life insurance payments) and car insurance (AZN9M, 9.3% of non-life insurance payments). Main growth in payments was on these insurance classes compared with June 2022. Payments on CCLIMVO increased by 11% and by 7%, on car insurance payments.

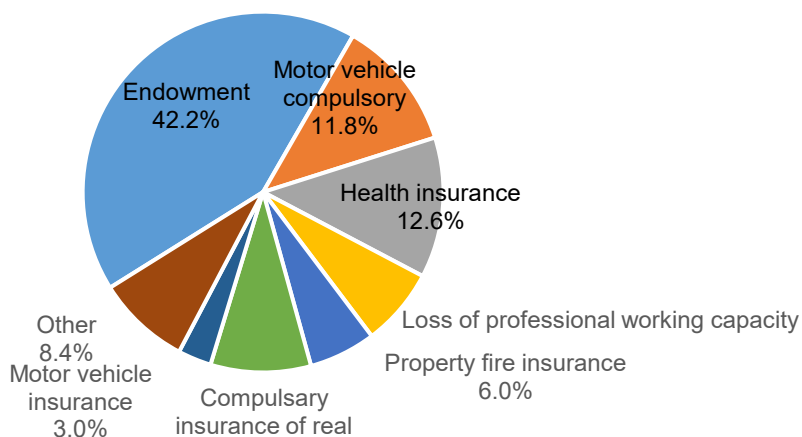
Chart 57. Structure of non-life insurance payments across classes



Source: CBA

There is concentration on classes in the insurance sector. Over half of insurance premiums is concentrated on three insurance classes. The share of three insurance classes in total premiums was 67% - endowment life insurance (42.2 %), medical insurance (12.6%) and compulsory car insurance (11.8%).

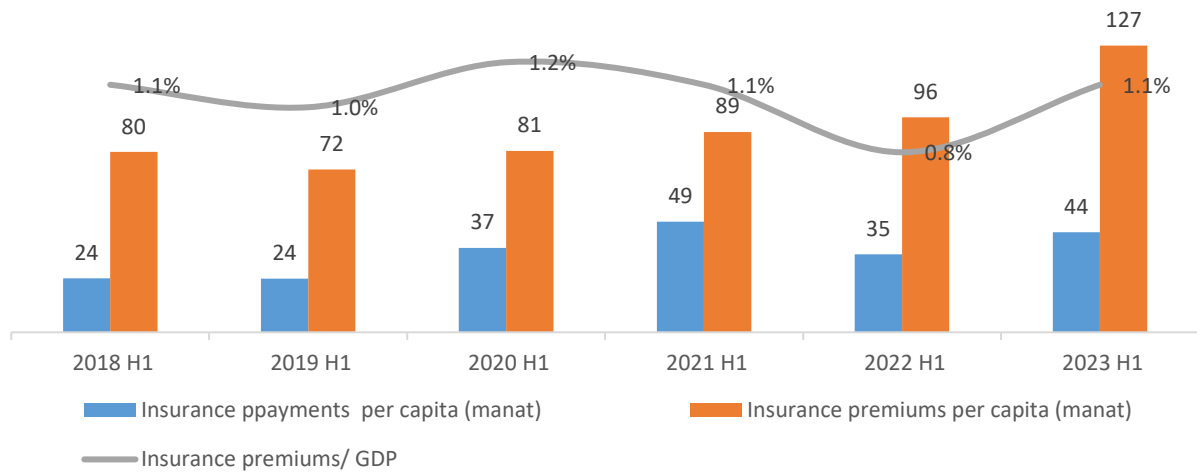
Chart 58. Breakdown of insurance premiums across classes



Source: CBA

Per capita insurance premiums and payments increased. Per capita insurance premiums increased by 32.3% to AZN127 and insurance payments increased by 25.7% to AZN 44M.

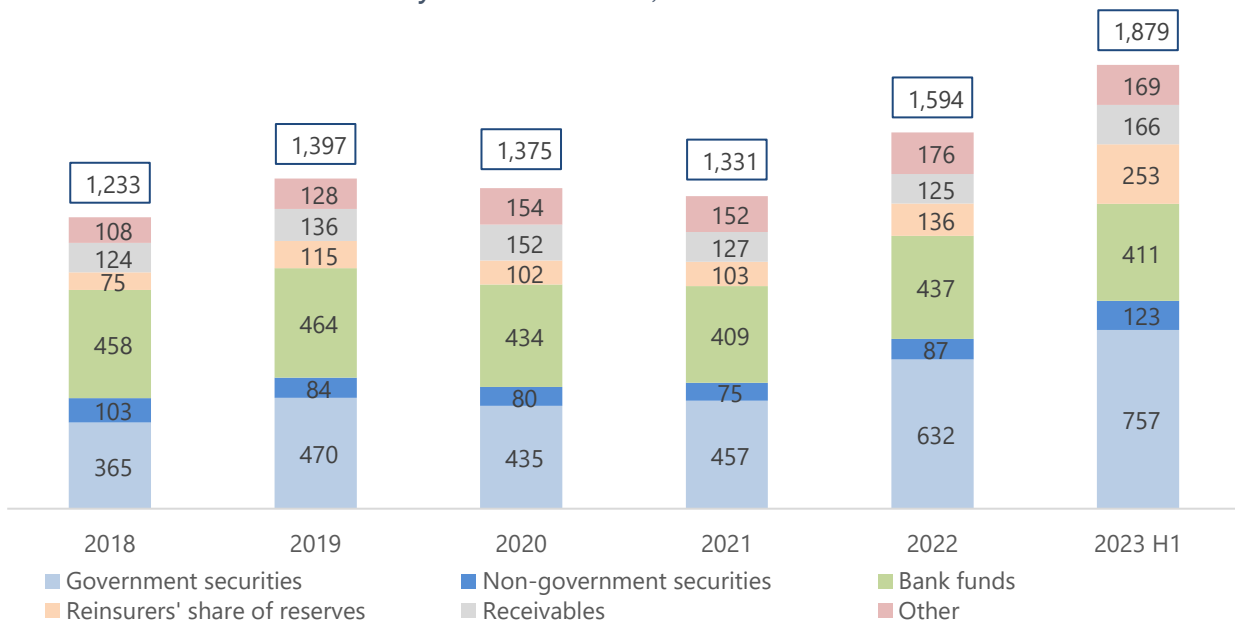
Chart 59. Insurance sector penetration



Source: CBA

Positive dynamics on assets of the sector continued in the first half of the year. Excluding bank funds, assets increased across all components, driven by GSs (AZN125.1M) and the share of the re-insurer in insurance reserves (AZN117.1M).

Chart 60. The structure and dynamics of assets, million AZN

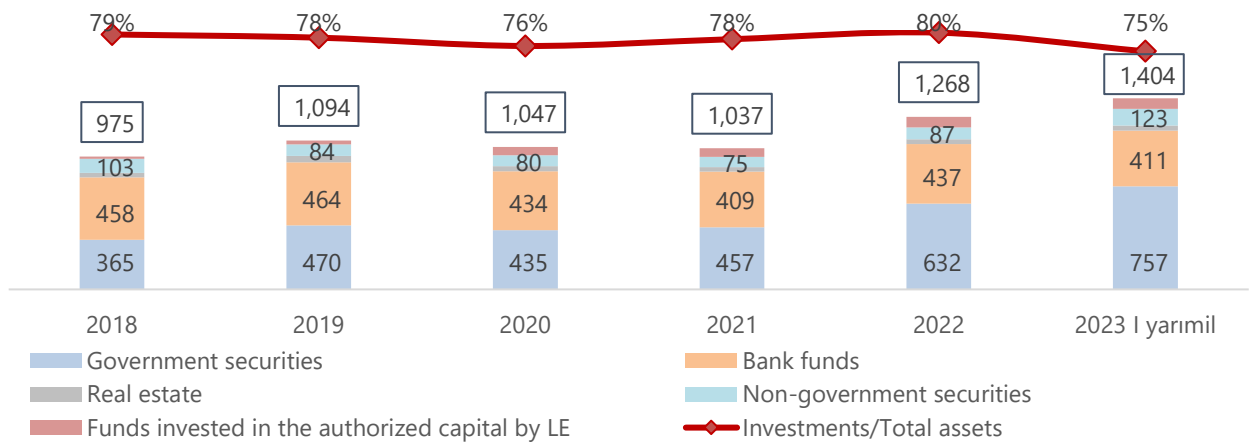


Source: CBA

Insurance companies have a potential as an institutional investor. Investments of insurance companies yoy increased by 10.7% to AZN1404M, driven by GSs (19.8%, or AZN125M). In general, the investment portfolio accounted for 90% of assets of life insurance companies and for 65% of assets of non-life insurance companies. Investment assets in life and non-life insurance companies consist of GSs

and bank funds. The rise in the range of local financial instruments is critical for investment activities of insurance companies.

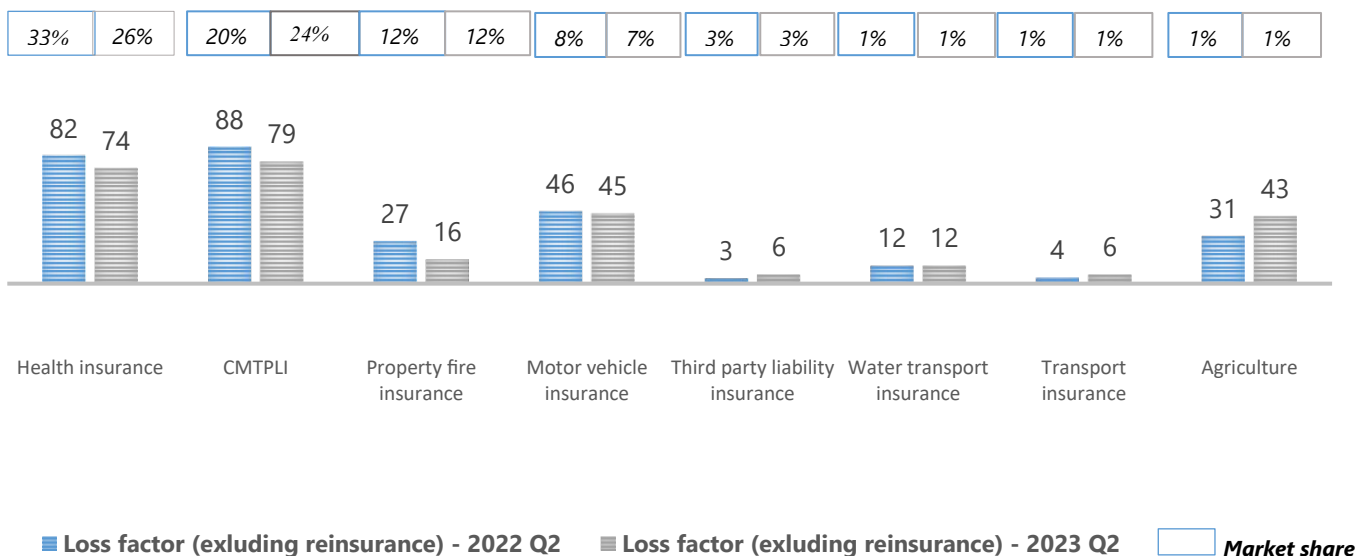
Chart 61. The structure and dynamics of the investment portfolio, million AZN



Source: CBA

The loss ratio decreased year over year – it decreased yoy by 3.1 pp to 55.9%, driven by the drop in the loss ratio across insurance classes. Nevertheless, the loss ratio remains high on certain non-life insurance companies.

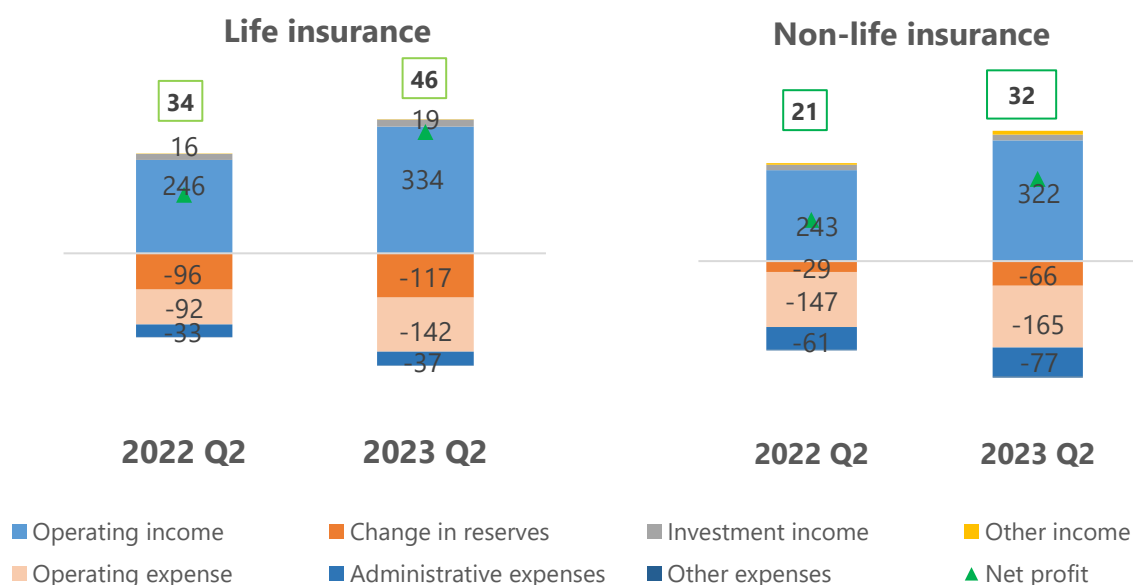
Chart 62. The structure and dynamics of the loss ratio , in percentage



Source: CBA

Profitability of insurance companies increased. Both life and non-life insurance companies generate more profit year over year. Net profit on life insurance companies yoy increased by 35% to AZN46 M, while that of non-life companies increased by 58% to AZN32M. In both cases the growth was driven by the rise in operational income.

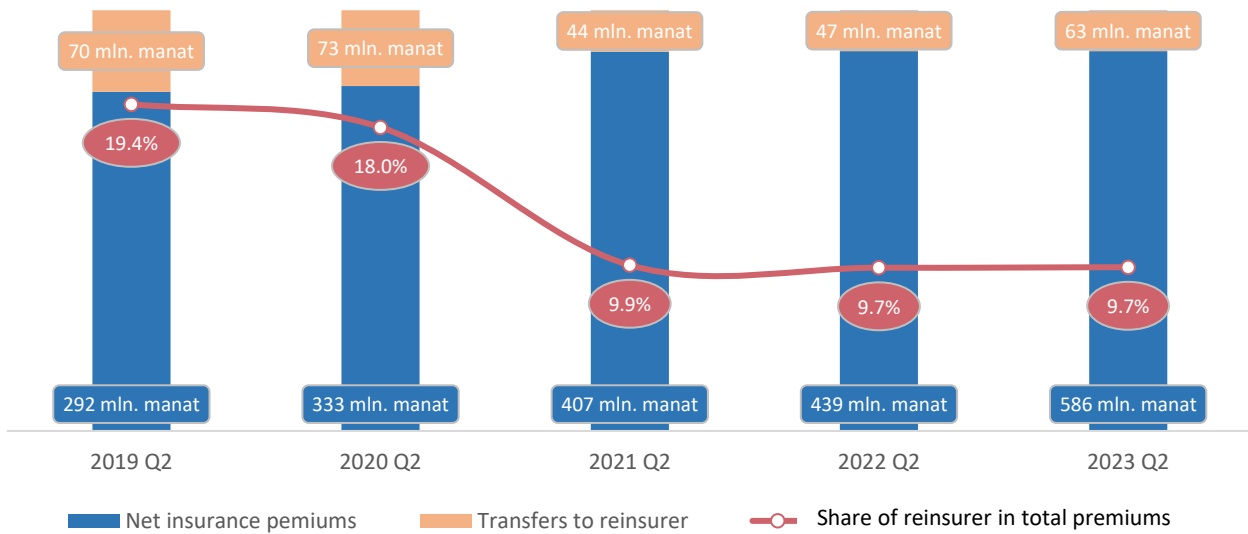
Chart 63. Profitability of the insurance sector



Source: CBA

Whereas the share of the amount transferred to re-insurance in insurance premiums remained unchanged, it is still low. Over first six months of the year the share of reinsurance in insurance premiums remained unchanged year over year (9.7%). The fact that the share of the amount transferred to reinsurance in insurance premiums is low was driven by the rise of life insurance premiums in total insurance premiums and low transfer by insurance companies with a high market share on non-life insurance to the reinsurer. Transfer of the risks of five insurance classes that cover about 87% of non-life insurance premiums is not high. 0% of the medical insurance that makes 26% and merely 24% of compulsory real estate insurance that makes 18% of non-life premiums was transferred to the reinsurer.

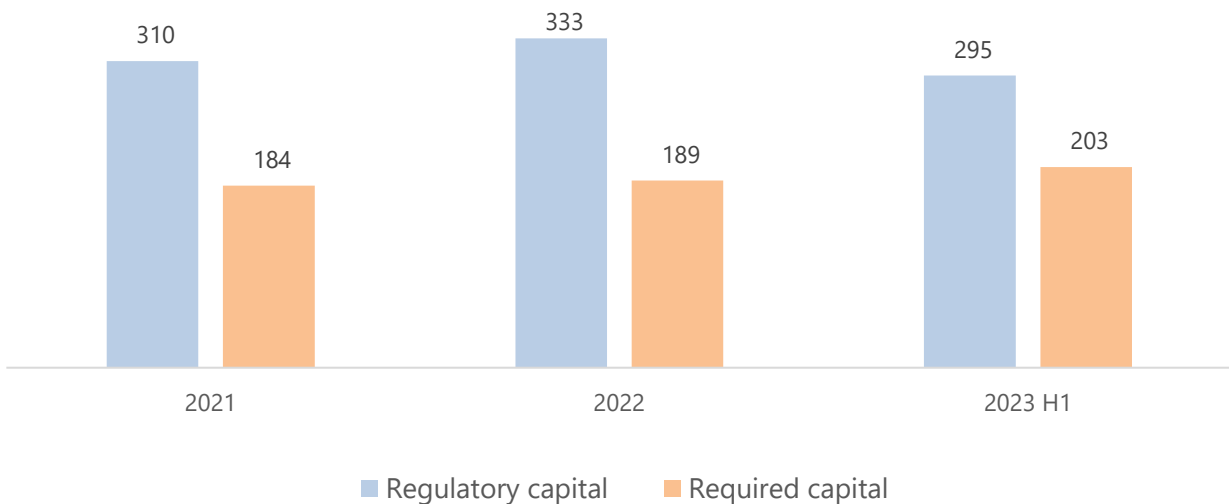
Chart 64. The share of the amount transferred to the reinsurer in insurance premiums



Source: CBA

Although aggregate capital decreased over recent six months, the sector has a sufficient capital buffer. In H1 2023 aggregate capital of the insurance sector decreased by 11.3% (AZN38M), while required capital increased by AZN14M (7.2%). Consequently, the aggregate capital to required capital ratio decreased by 31 pp to 145%.

Chart 65. The dynamics of aggregate and required capital

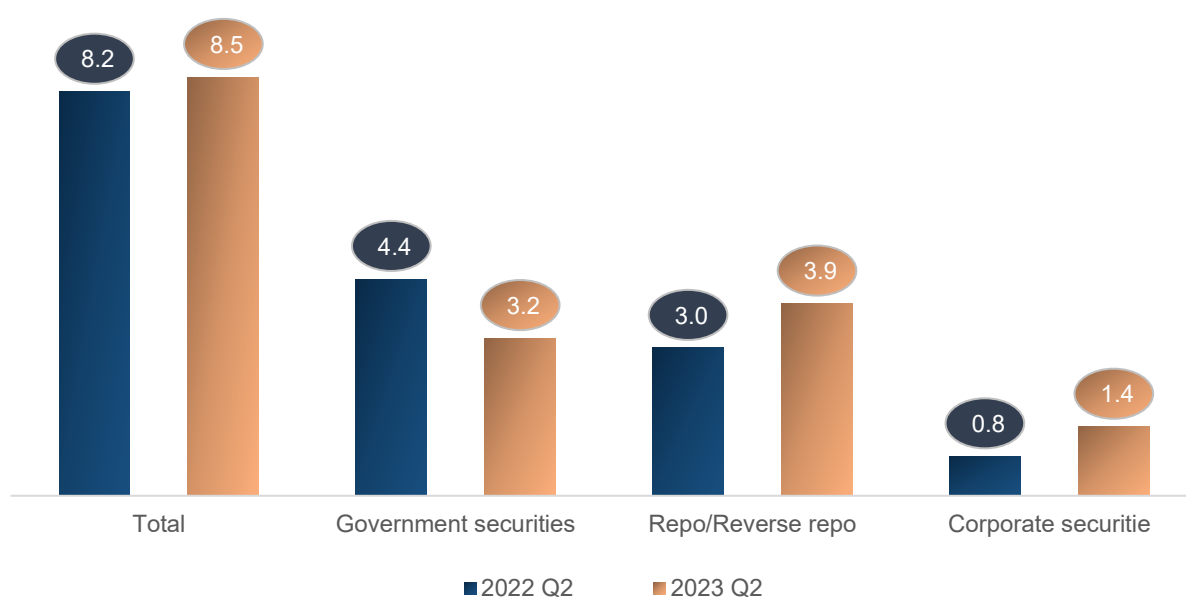


Source: CBA

Capital market

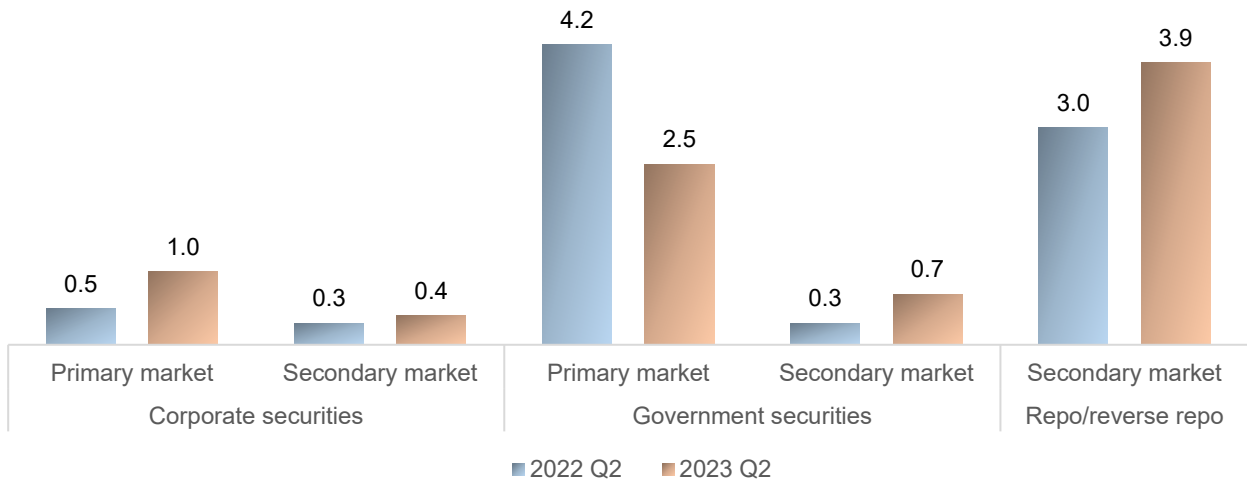
Whereas the turnover of GSs decreased year over year, total turnover of the securities market increased. Trade turnover of the securities yoy increased by 3.5% to AZN8.5B, driven by repo/reverse repo operations. Repo/reverse repo operations yoy increased by 30% (AZN0.9B) to AZN3.9B. On the other hand, the turnover of the corporate securities market increased by 75% (AZN0.6M) to AZN1.4B. The turnover of the GSs market decreased by 28.4 % (AZN1.3B) to AZN3.2B.

Chart 66. Capital market turnover, billion AZN



Source: CBA

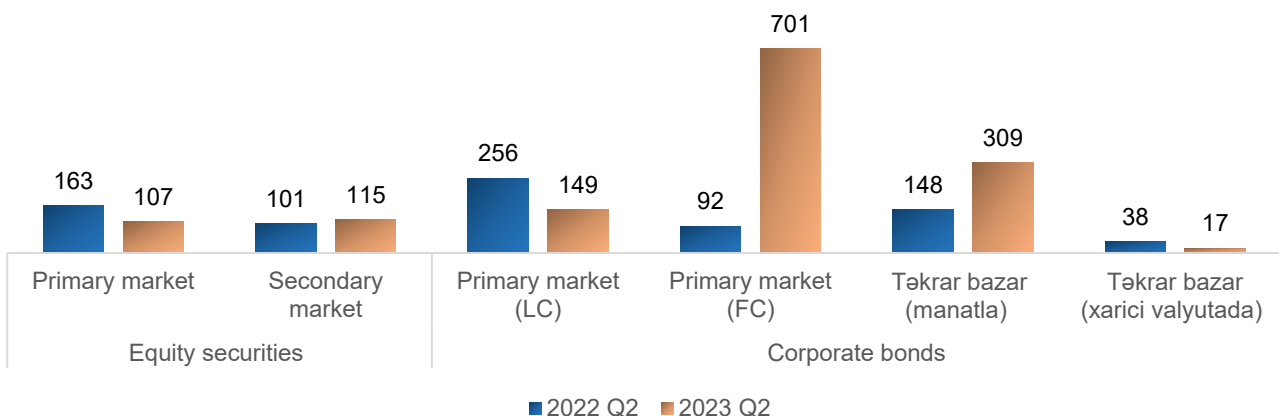
Chart 67. Volume of operatoin in primary and secondary markets, billion AZN



Source: CBA

The dynamics of the corporate securities market was driven by corporate bonds in the primary market. The corporate bond market turnover yoy increased by 120%, while the stock market turnover decreased by 16%. The volume of operations both in national and foreign currencies in the corporate bonds market increased. The key driver on the corporate securities market was corporate securities in a foreign currency traded in the primary market. The volume of operations with corporate securities in the regulated market increased. Placement of corporate securities by public offering at the Baku Stock Exchange increased, resulting in 16% rise in the volume of corporate securities at the primary market, and by 74% at the secondary market. Growth stood at 32% on repo operations.

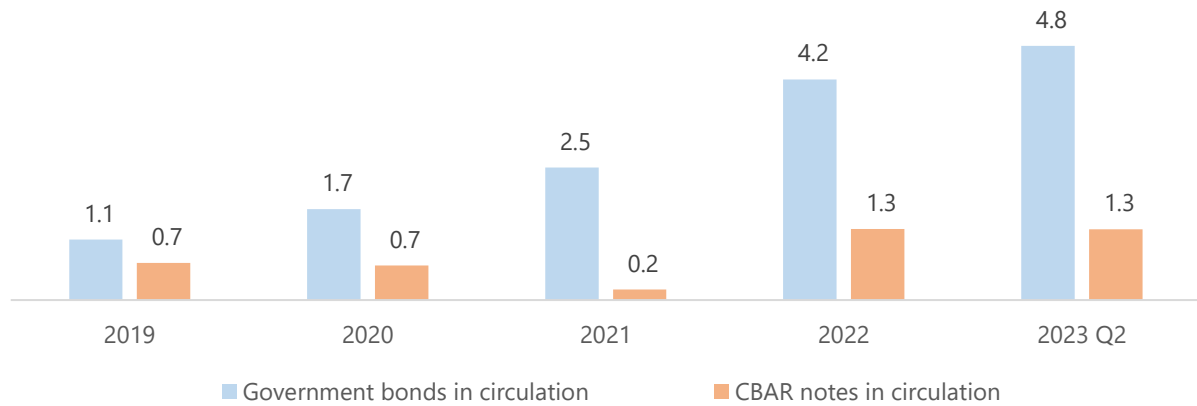
Chart 68. Volume of transactions in the corporate securities market, million AZN



Source: CBA

The volume of GSs in circulation increased, driven by government bonds. The volume of government bonds in circulation in H1 2023 increased by 15.2%(AZN0.6B) to AZN4.8B compared with the end of previous year. The volume of government bonds increased at the expense of the issue of long-term GSs.

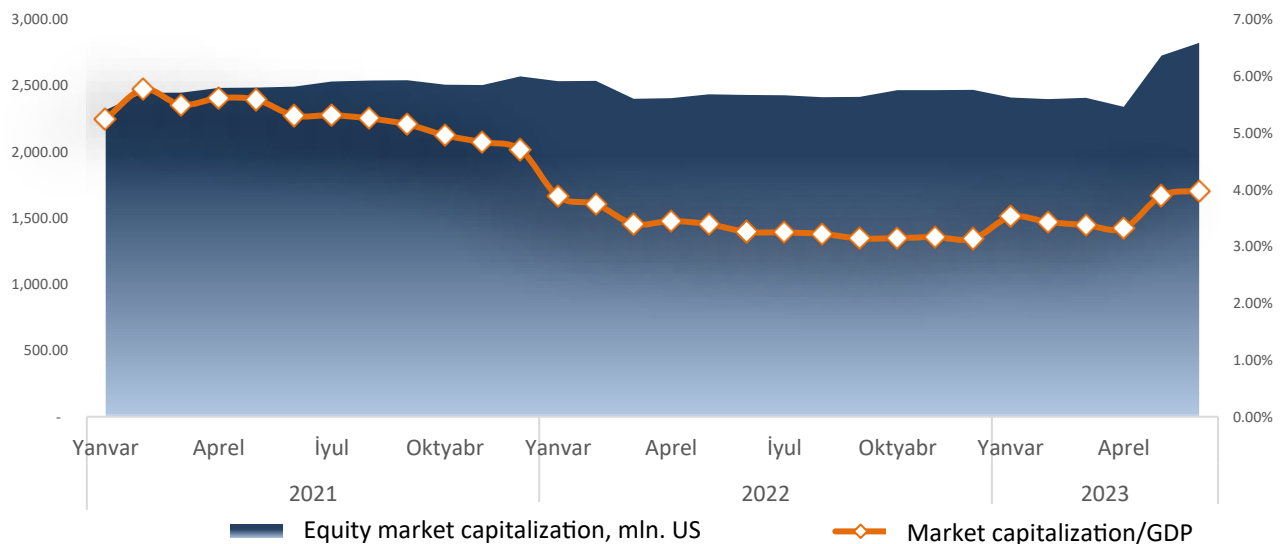
Chart 69. Dynamics of government bonds in circulation, billion AZN



Source: CBA

The potential for higher penetration and depth of the capital market remains high. In H1 2023 capitalization of the stock market increased by 15.6% (AZN385B) to AZN2.85B and the depth of the stock market increased by 0.88 pp to 4.02% amid the rise in market capitalization of the stock market.

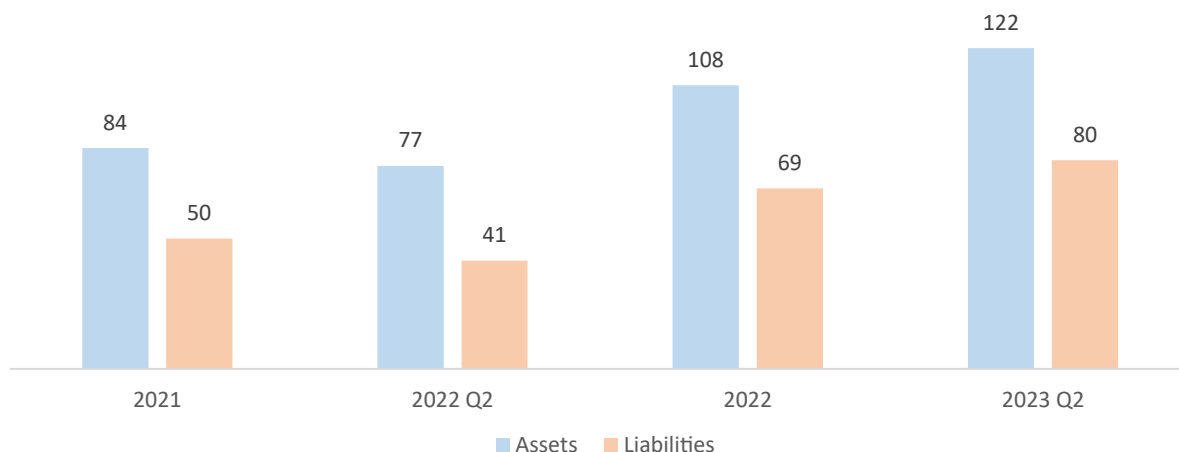
Chart 70. Stock market capitalization and penetration



Source: CBA

The balance sheet of investment companies expanded. Compared to the beginning of the year investment company assets increased by 13% to AZN122M, while liabilities increased by 16% to AZN80M.

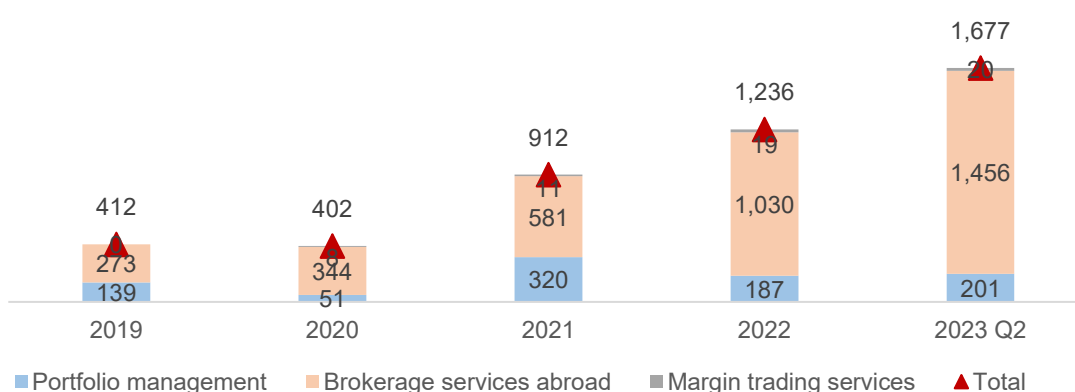
Chart 71. Dynamics of the balance sheet of investment companies, million AZN



Source: CBA

Customer assets of investment companies expanded over the period. Customer assets of investment companies increased by 36% (AZN441M) to AZN1677M compared with the end-2022, driven by brokerage services in the foreign market. In H1 2023 customer assets on brokerage services in the foreign market increased by 41% (AZN426M). While the rise in customer assets across the sector is positive, there is a high concentration of customer assets in the sector.

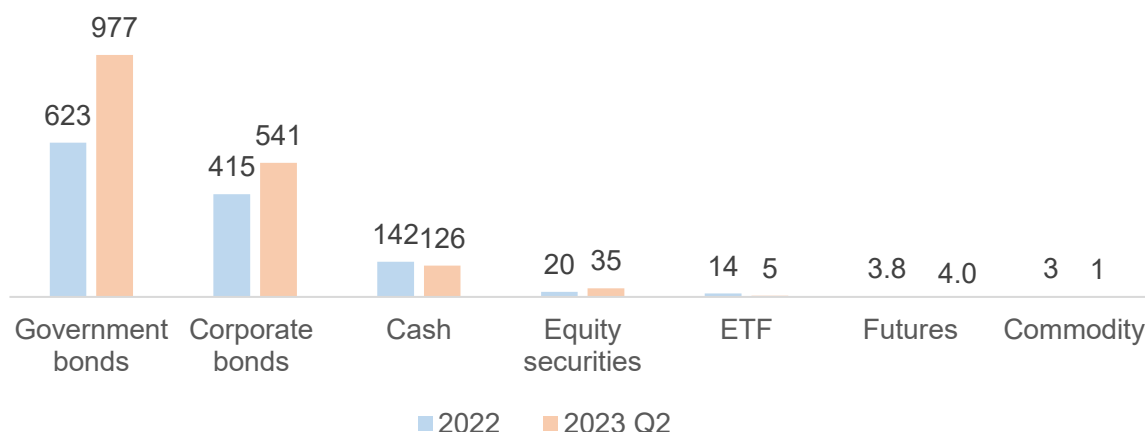
Chart 72. Dynamics of customer assets of investment companies, million AZN



Source: CBA

Customer assets are invested in low-risk securities. In H1 2023 investors invested 58% (AZN977M) of their funds in low-risk government bonds, 32% (AZN541M) in corporate bonds, and 7% (AZN126M) in money funds. On the backdrop of small

Chart 73. Structure of customer assets in terms of the types of customer assets, million AZN

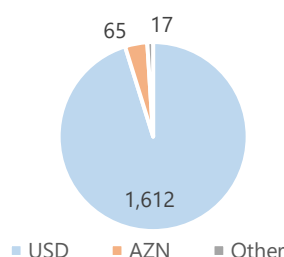


Source: CBA

number of risky investments in the market, demand for derivative financial instruments was low. As we can see

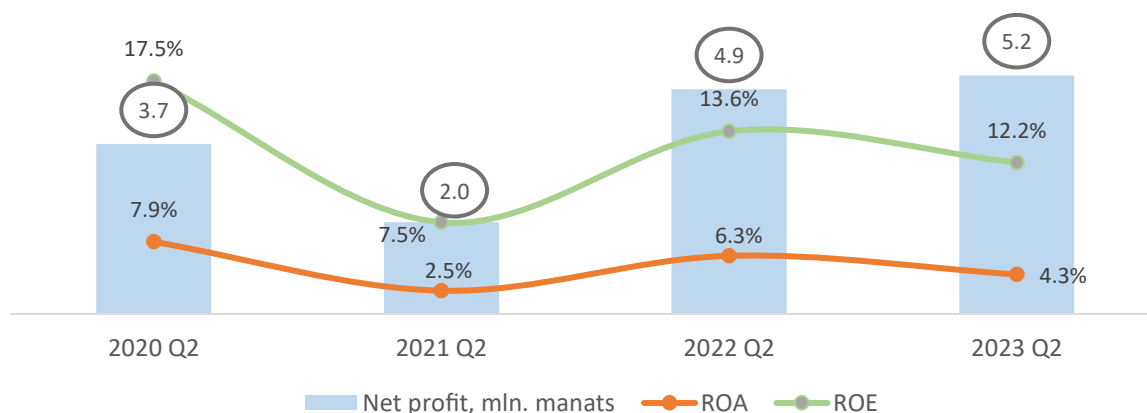
from the currency structure of *Chart 74. Currency structure of customer assets* customer assets, 95% of customer assets is denominated in the USD.

A positive trend in profitability of investment companies continued. In H1 2023 net profit of investment companies increased



Source: CBA

Chart 75. Profitability of investment companies

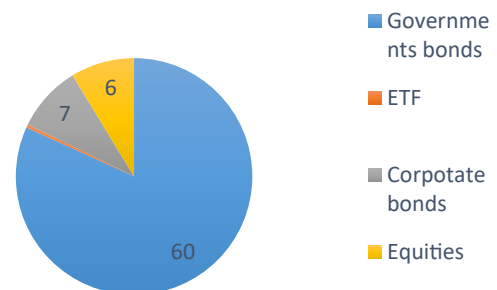


Source: CBA

by 6.3% (AZN0.3M) to AZN5.2M. Although profitability of the sector was positive, growth was higher on assets and capital, resulting in decrease of ROA and ROE to 4.3% and 12.2% respectively.

The trade book of investment companies being poorly diversified includes government bonds. In H1 2023 the trade book of investment companies amounted to AZN73M. The main part of the trade book comprises of low-risk government bonds. The book comprises of 82% government bonds, 9% corporate bonds, 8% stocks and 1% exchange traded funds (ETF).

Chart 76. The structure of the trade book, million AZN

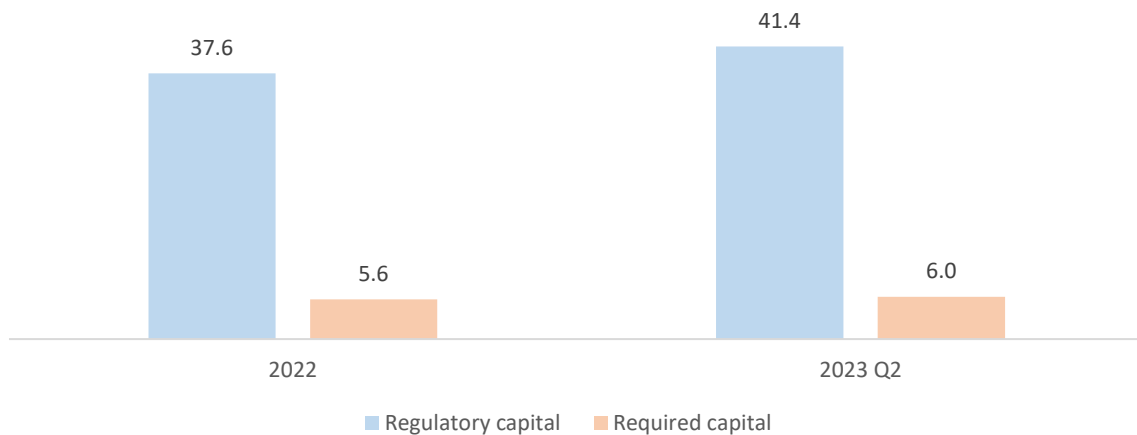


The capital position of investment companies is in a comfort zone. As of end

Source: CBA

of the first half of 2023 aggregate capital of the sector stood at AZN41.4M and required capital at AZN6.0M, requiring investment companies to have a sufficient capital buffer.

Chart 77. Dynamics of regulatory and required capital, million AZN



Source: CBA

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