CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

FINANCIAL STABILITY REPORT

2022

Central Bank of the Republic of Azerbaijan

FINANCIAL STABILITY REPORT*

*** The report is based on data as of December 2022.**

ACRONYMS

CBA – Central Bank of the Republic of Azerbaijan

MCGF – Mortgage and Credit Guarantee Fund of the Republic of Azerbaijan

SOFAZ – State Oil Fund of the Republic of Azerbaijan

ADB – Asian Development Bank

OCP – open currency position

DTI – debt-to-income ratio

NBCI – non-bank credit institution

IMF – International Monetary Fund

WB – World Bank

SCC – State Customs Committee

GS – government securities

SSC – State Statistics Committee

MLSPP – Ministry of Labor and Social Protection of the Population

p.p. – percentage point

HP – Hodrick-Prescott filter

LE – legal entity

LC – local currency

FC – foreign currency

AEs – advanced economies

EMEs – emerging market economies

CA – capital adequacy

CAR – capital adequacy ratio

NPL – non-performing loans

NGS – non-government securities

MSME – Micro, small and medium enterprises

NC – national currency

yoy – year over year

ROA – return on assets

ROE – return on equity

RWA – risk weighted assets

GDP – gross domestic product

OVDL – overdue loans

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Executive summary

In 2022 the global environment was marked with high geopolitical and geoeconomic tension, stronger inflationary pressures, economic contraction in AEs and monetary policy tightening in most countries. On the backdrop of uncertainties triggered by geopolitical and geoeconomic risks the CBA pursued a policy oriented towards safeguarding macro-economic and financial stability under its mandate.

Over the year, the banking sector was in general resilient against exogenous shocks.

The credit risk subdued amid positive dynamics in quality of assets and more advanced risk management in credit institutions. Recent changes to the macro prudential framework underpinned reduction of credit risks and neutralization of potential risks in the sector.

The currency position of the sector was within normative requirements. De-dollarization trends of recent years continued.

Being in historical highs sector's liquid assets were capable to absorb liquidity shocks. The instant liquidity ratio of the sector surpassed the minimum requirement by two times.

Profitability of the sector continues to post a positive trend. The capital position exceeds prudential norms and is capable to absorb potential risks.

Financial indicators of the insurance sector continued to post growth. Whereas the penetration level of the insurance sector decreased, per capita insurance premium increased. The investment portfolio accounts for the four fifths of the insurance sector assets, increasing the role of the insurance sector in the financial system as a critical institutional investor. Profitability of the insurance sector rose. The capital position of the sector exceeds prudential requirements.

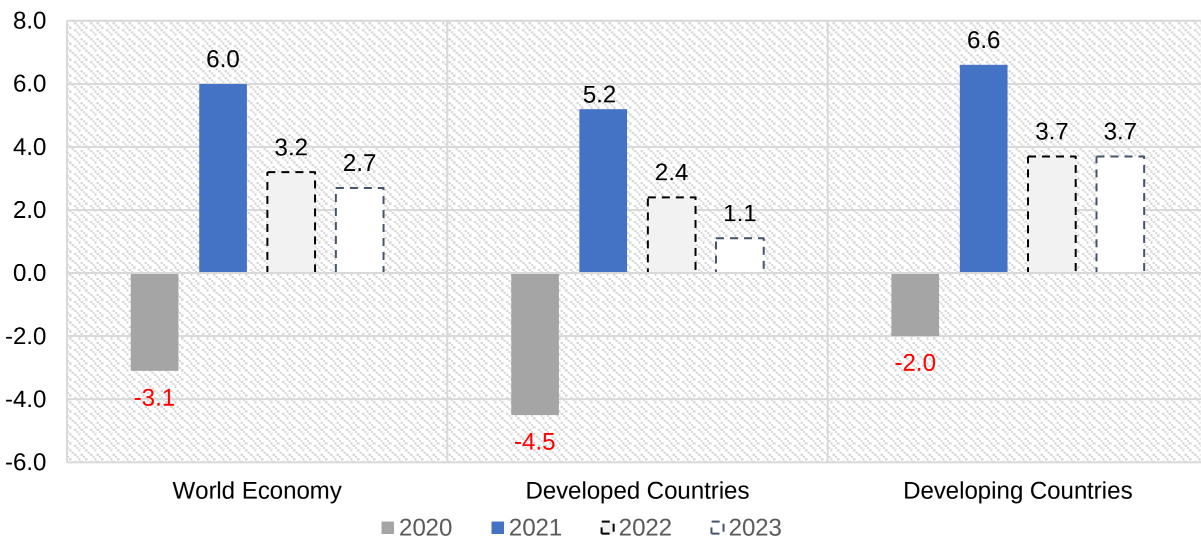
To increase the role in support for access to finance of the economy efforts continued to improve the operating infrastructure of the capital market, align the legal framework to international standards, and back supply and demand in the market. While the securities market decreased year over year, circulation of government securities increased. The role of investment companies in financial intermediation is increasing. Growth was high on assets of the sector and customer assets.

Global macroeconomic environment

In 2022, the global environment reacted to high geopolitical and geoeconomic tension, strong inflationary pressures, economic contraction in AEs and monetary policy tightening in most countries. The rise in uncertainties in the global economy and in risks was driven by the Russia-Ukraine conflict and its influence on food and energy prices, weak recovery of the pandemic triggered supply chain disruptions and higher than expected economic contraction in China amid tight quarantine measures in China and slowdown in the property market. High global inflation and weak economic activity activated risks of stagflation in certain countries.

On the backdrop of accumulation of risks in the world economy and high uncertainty, the IMF revised global economic growth forecasts. Whereas the IMF WEO June 2022 forecasted 2.9% growth of the global economy, in WEO October 2022 the IMF revised this forecast down by 0.2 p.p. to 2.7%. Forecasts were revised down by 0.3 and 0.2 pp to 1.1% and 3.7% for AEs and EMEs respectively.

Chart 1. GDP growth forecasts, in percentage

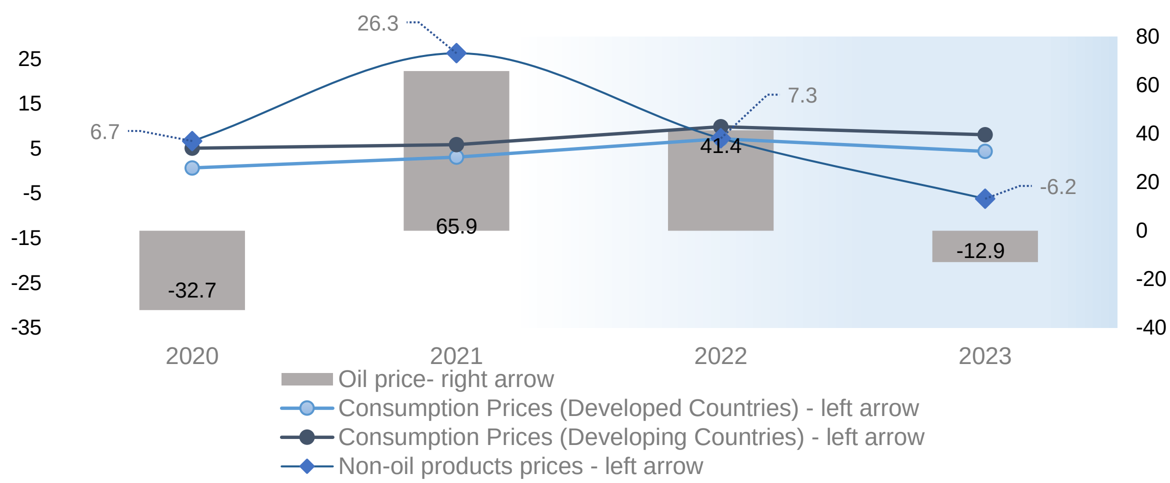


Source: IMF, World Economic Outlook October 2022

Rising inflation amid geopolitical developments acted as the main threat to global financial stability. Significant reduction in and suspension for a certain period of natural gas supply from Russia to Europe, including the EU embargo on Russian coal and setting a cap for the oil price pushed energy prices up. At the same time, geopolitical tension and sanctions contributed to food price hikes. Moreover, post-pandemic high demand was another factor to push inflation. Core inflation was the main driver of global inflation. As a result, annual inflation in the USA reached the highs of recent 40 years – 6.5%, annual inflation stood at 9.2% and 10.5% in Europe and the UK respectively.

Rising inflationary pressures forced most central banks to tighten the monetary policy. Over the year the US Fed shifted the policy rate from 0-0.25% to 4.25-4.5%, the Bank of England from 0.25% to 3.5%, and the ECB increased each of three key interest rates by 2.5 pp[1]. In 2022, total 70 central banks took 357 decisions to increase and 8 banks took 18 decisions to decrease policy rates, while 10 central banks left interest rates unchanged. Monetary tightening is expected to gradually tame inflation in 2023 and 2024. According to the IMF, the global consumer price index is expected to drop to 6.5% in 2023 and to 4.1% in 2024 from 8.8% in 2022.

Chart 2. Commodity price changes, in percentage



Source: IMF World Economic Outlook October 2022

Monetary tightening strained financial conditions in EMEs and increased financial stability risks. According to the IMF WEO financial vulnerabilities surged mainly in non-financial institutions. Due to higher expenses in large non-financial corporations, profit margin dropped, while default probability is high in small companies due to high funding rates and low fiscal support.

Liquidity risks are rising in global financial markets. Supply-demand spreads of US Treasury bills, the main liquidity driver in the global market, increased considerably. In general, liquidity premiums are rising and liquidity is dropping across all asset classes. According to the IMF WEO, margin challenges on derivative financial instruments were used to hedge the effect of high and volatile energy prices expected in Europe, which in its turn resulted in emergence of the liquidity problem in high energy consuming

[1] *Deposit interest rate: from 0.5% to 2%, interest rate on key refinancing operations: from 0% to 2.5% and marginal lending interest rate: from 0.25% to 2.75%.*

companies and allocation of short liquidity lines and credit guarantees for these companies by a number of European governments.

Property market risks elevated in both AEs and EMEs. Rising mortgage rates and harder lending conditions amid monetary tightening affected negatively the dynamics of the real estate market. The real estate crisis in China increased threats to the local banking system resilience and had a negative effect on economic growth.

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

	Fiscal balance				State debt			
			Forecast				Forecast	
	2021	2022	2023	2024	2021	2022	2023	2024
AEs	***-7,2***	***-3,6***	***-3,7***	***-3,8***	***117,9***	***112,4***	***111,3***	***111,8***
USA	-10,9	-4,0	-5,7	-6,6	128,1	122,1	122,9	126,0
Euro area	-5,1	-3,8	-3,3	-2,8	95,3	93,0	91,3	89,8
Japan	-6,7	-7,9	-3,6	-2,5	262,5	263,9	261,1	260,3
EMEs	***-5,3***	***-6,2***	***-5,4***	***-5,5***	***64,4***	***65,1***	***68,5***	***71,6***
Asia	-6,6	-8,6	-7,0	-7,2	71,2	75,4	80,8	85,2
Europe	-1,9	-3,0	-2,8	-2,7	35,8	31,6	31,9	32,7
Latın America	-4,5	-4,2	-4,7	-4,0	72,2	68,0	68,1	68,9
Middle east and North Africa	-3,1	0,8	-0,6	-1,2	48,0	40,6	39,5	39,5

Source: IMF, Fiscal monitor, October 2022

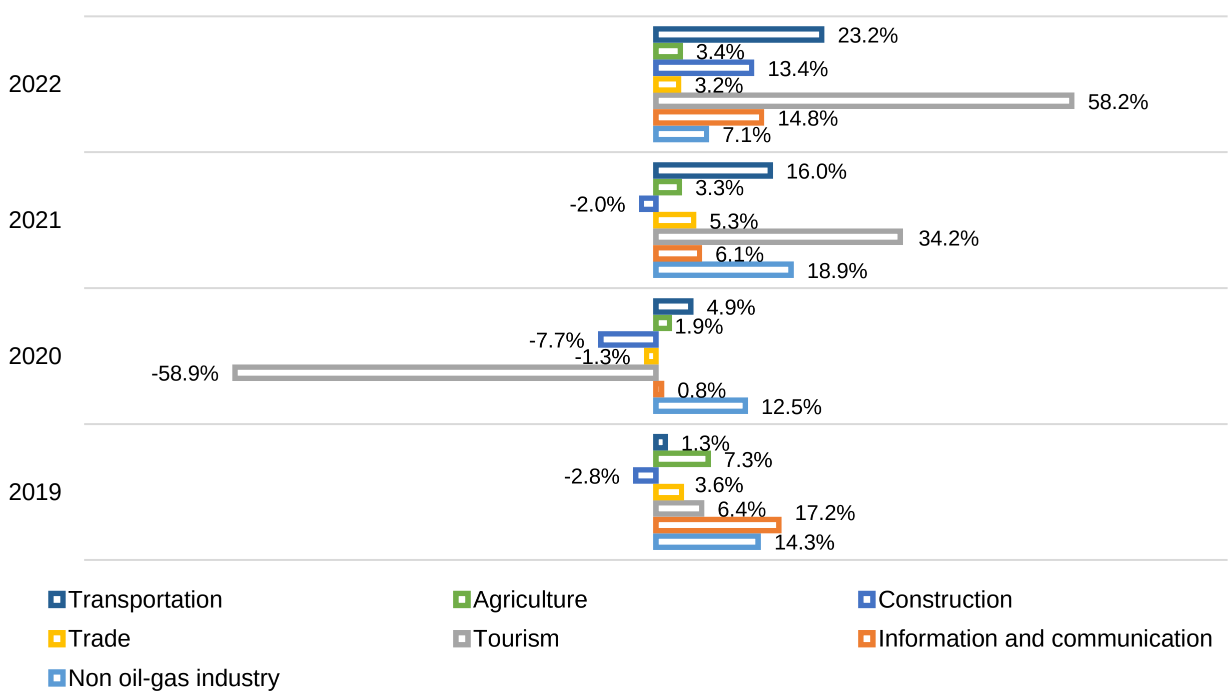
While fiscal deficit decreased, it is still high compared to the pre-pandemic period. Suspension of pandemic-related fiscal support programs contributed to the drop in fiscal deficit. At the same time, high energy prices had an upward effect on the fiscal position of oil exporters. However, increase in policy rates by central banks and tightening of financial conditions in global markets stretched debt burden of EMEs. Rising food prices had a downward effect on the fiscal position of EMEs. The global state debt to GDP ratio was 91%, up by 7.5 pp compared to the pre-pandemic period.

Macroeconomic environment in Azerbaijan

Inflationary pressures rising on the backdrop of uncertainties triggered by global geopolitical and geoeconomic risks weighed on the Azerbaijani economy in 2022 as well. GDP increased by 4.6% in real terms to historical highs in nominal terms – AZN133.8B. Economic growth was driven by the non-oil sector. The value added in the oil and gas sector decreased by 2.7% and increased by 9.1% in the non-oil and gas sector. The non-oil sector accounted for 52.2% of GDP. Per capita GDP yoy increased by 4.1% to AZN13.3 thousand.

In 2022 nearly all areas of the non-oil sector posted growth. The falling trend in the construction sector was replaced with the rising one, attributable to large-scale construction-rebuilding efforts in liberated territories. Non-oil economic growth was 7.1%. Tourism, transportation and catering posted rapid growth.

Chart 3. Non-oil economic growth



Source: SSC

Nominal income and nominal salary of the population increased. As of end-2022 labor force numbered 5358.4 thousand persons, out of which the number of employed population was 5056.2 thousand persons. Salaried labor was 1732.5 thousand persons – 52% (903.3 thousand persons) was engaged in the public sector and 48% (829.2 thousand persons) in the non-public sector. In 2022 average monthly nominal income of salaried labor increased 14.6% to AZN829.9. Nominal income of the population yoy increased by 20.5% to AZN68.9B.

Amid global supply chain disruptions triggered by geopolitical tensions surge in energy and food prices contributed to high inflation. According to the SSC, in 2022 annual (December 2022 vs December 2021) inflation stood at 14.4% and average annual inflation (January-December 2022 vs January-December 2021) stood at 13.9%. Annual and average annual core inflation was 14% and 11.7% respectively. Annual inflation peaked in September and dropped towards the end-year.

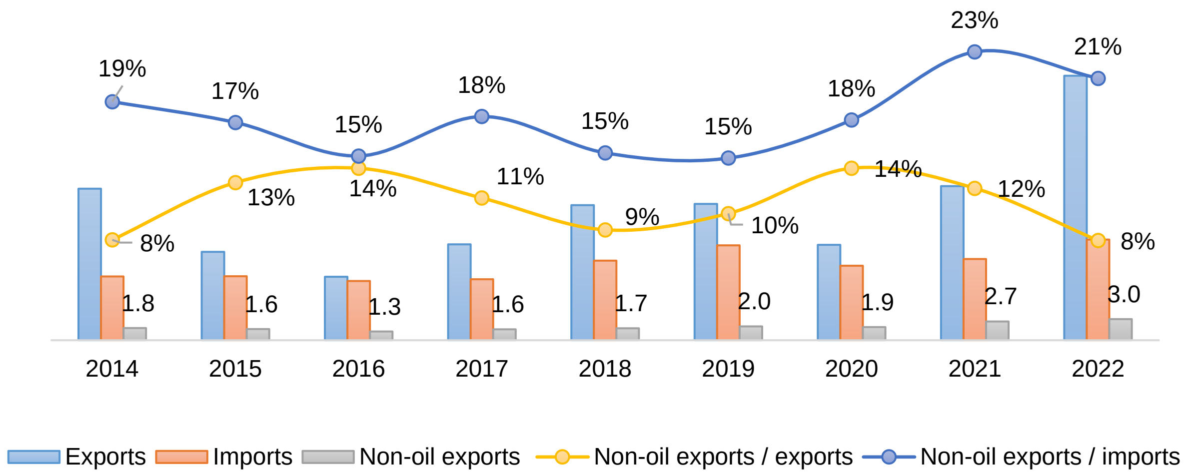
Food price hike made more contribution to total inflation. Annual food inflation reached 19%. Annual price hike on other inflation components – non-food products and services was 11.9% and 10.2%. In general, domestic inflation was driven by the rise in global energy and food prices, as well as inflation in trade partners. Wider aggregate demand allowed transformation of rising foreign cost factors to prices. In 2022 appreciation of the nominal effective exchange rate of the manat had a containing effect on imported inflation.

The monetary policy of the CBA was oriented towards easing inflationary pressures. The Bank discussed interest rate corridor parameters 9 times in 2022 and decided to shift the refinancing rate to 8.25% from 7.25%, and the ceiling of the interest rate corridor to 9.25% from 8.25%. The floor of the interest rate corridor was reduced to 4% from 6.25% on 1 September 2022 with the new configuration of monetary policy tools. Reduction of the floor of the interest rate corridor was found expedient in terms of sterilization of excess liquidity in the banking sector under favorable conditions and creation of options for formation of balanced interest rates in the interbank money market. However, according to the prior explanatory note the Bank considered the width of the corridor and increased the floor of the corridor to 5% in October and 6.25% in December.

The CBA took a number of actions to improve the monetary policy operational framework, in particular strengthen the pass-through of the refinancing rate. New monetary policy tools were introduced on 1 September 2022 and the money market infrastructure was improved. These measures began to yield positive results. Interest rates in the interbank market started to react to the change in the interest rate corridor for the first time.

The Bank decided to utilize **reserve requirements** more actively to regulate effectively money supply amid rising inflationary pressures. The Management Board of the Central Bank decided to set a 4% reserve requirement on deposits in the national currency and precious metals and 5% on foreign currency denominated deposits. On September 15, banks began to maintain reserve requirements under new norms.

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



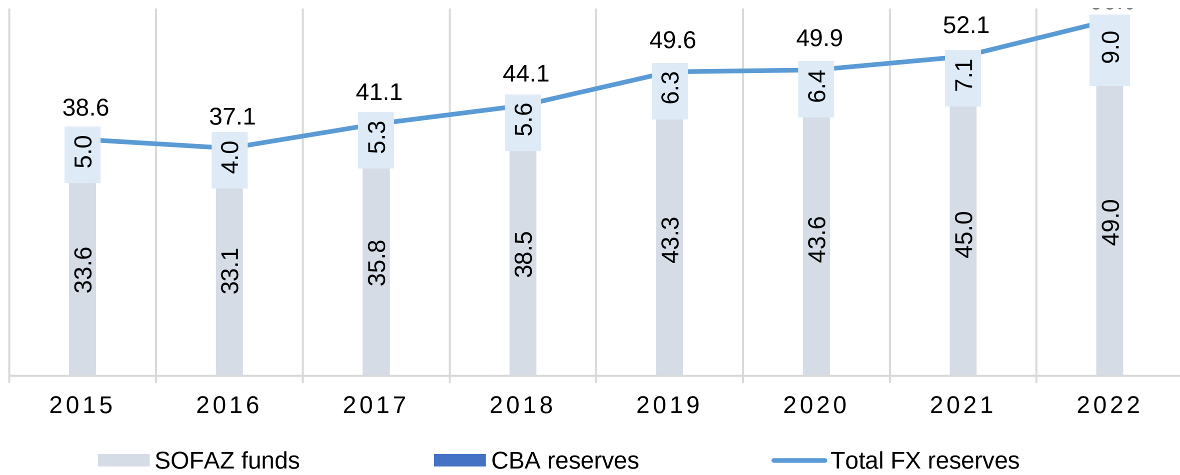
Source: SCC

In 2022 the foreign trade position improved compared to the previous year. According to the SCC, export yoy increased by 72% ($15.9B) to $38B, while import increased by 24% ($2.8B) to $14.5B. Non-oil export yoy increased by 12.6% to $3B. High rise in export is attributable to expanded export both of energy carriers, in particular natural gas, and of non-oil export.

The balance of payments indicators improved amid high global commodity prices and non-oil export. Over 9 months of 2022 current account surplus increased by $17.7B (30.7% of GDP). In addition, foreign trade surplus yoy increased by 3.3 times to $21.2B. According to the BoP of 9 months of 2022 remittances to foreign countries increased by 3.6 times to $2.8B, while remittances from foreign countries increased by 29.6% to $0.5B, resulting in $2.3B worth surplus on remittances.

Long-term growth dynamics of FX reserves continued. FX reserves have been growing since 2016 driven by both funds of the SOFAZ and FX reserves of the CBA. FX reserves of the CBA increased by 27% to $9B, the highest annual growth rate of recent 5 years. In general, FX reserves of the country reached the highs of recent years.

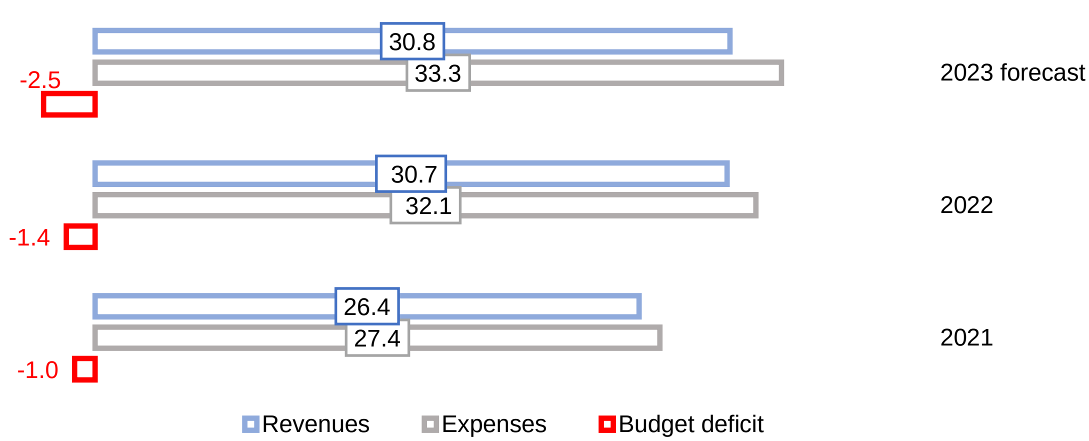
Chart 5. FX reserves of the CBA and the SOFAZ, billion USD



Source: CBA and SOFAZ

Fiscal expenses were crucial in supporting economic activity in the country. Based on operational performance data amid support for economic growth, actions taken to boost well-being of the population and restoration of liberated territories, state budget revenues made AZN30.7B, while expenses made AZN32.1B, resulting in AZN1.4B worth deficit (1% of GDP). In 2023 state budget revenues are set as AZN30.8B and expenses as AZN33.3B. In addition, AZN3.0B worth funds were allocated to rebuilding and restoration of liberated territories.

Chart 6. State budget revenues and expenses, billion AZN

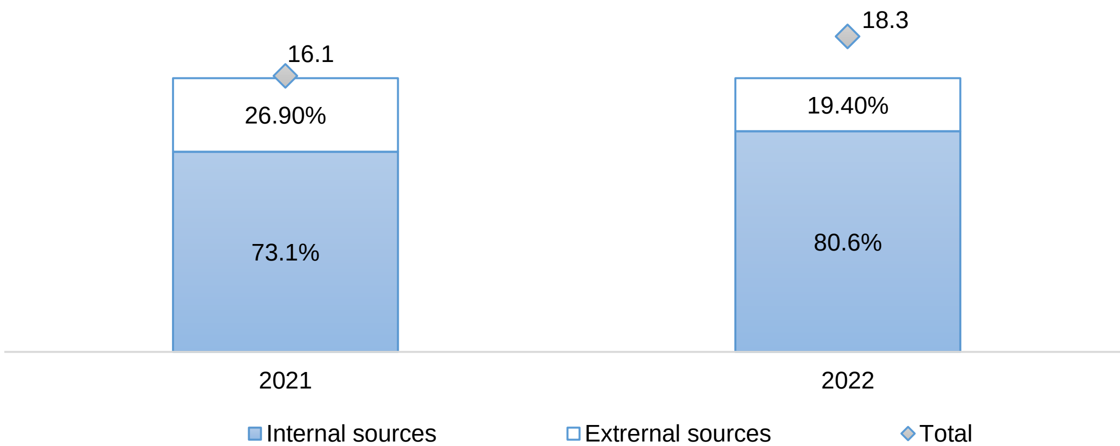


Source: CBA (SSC data based)

Investment to capital increased. According to the SSC, in 2022 funds channeled to socio-economic development increased by 5.5% to AZN18.3B. In general, domestic investments amounted to AZN14.7B (80.6%). Non-oil investments increased by 13.6%.

Although high global inflation rate remains as a risk amid uncertainties related to global geopolitical and geoeconomic situation, rapid economic growth recovery, foreign trade surplus and rise in FX reserves allow maintaining stability of the macroeconomic environment where the financial system operates.

Chart 7. Structure of investment to capital, billion AZN

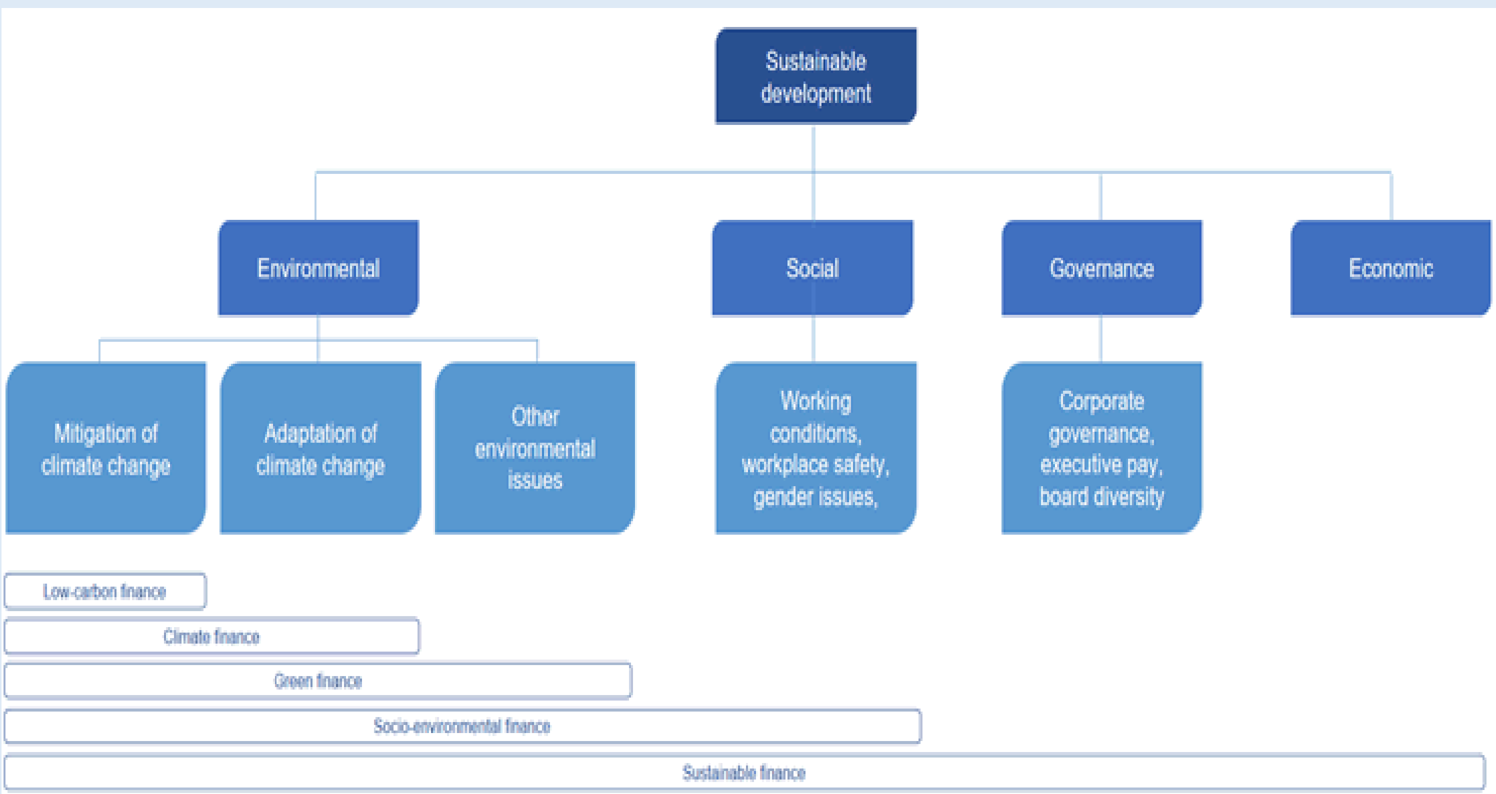


Source: SSC

Box 1. Strategic vision of the CBA on sustainable finance

Sustainable finance broadly refers to financing and the associated institutional and market infrastructure that helps deliver strong, sustainable and balanced growth aimed at achieving sustainable growth goals. Sustainable finance as a new paradigm focuses on climate change mitigation and adaptation, integrating ESG criteria into financial services. Among environmental, social and governance factors due to the expected scope of the impact and urgency of taking action more, climate-related and environmental risks are expected to become more prominent. Since in its turn climate changes and energy transition threaten financial stability, central banks and financial markets supervisory authorities began to take relevant actions. Feeding sustainable funding criteria into the analytical and policy framework is of current concern for central banks and financial regulators. Regulators and central banks have taken considerable number of actions over recent several years to promote sustainable finance.

Chart 8. Components of sustainable growth and sustainable finance



Source: UN

The Central Bank approved a Sustainable Finance Roadmap to ensure financial sector resilience to risks emerged from climate changes and other ESG (ecologic, social and governance) factors in light of international challenges and socio-economic growth targets of the country. Actions determined by the Roadmap cover issues, like systematic assessment of the impact of financial institutions' financing and investment decisions on environment and ecology, management of risks emerged from climatic and ESG factors, build an appropriate ecosystem for financial institutions to turn climate-related and environmental risks into opportunities, promotion of financial transparency and market discipline. Taking into account best practices actions on main sustainable finance components will be taken in a structured mannet. The Roadmap consists of four strategic priorities:

1. Capacity building in sustainable finance
2. Build an ecosystem for sustainable finance flows
3. Integrate climate-related risks and ESG factors into risk management
4. Ensure market transparency and discipline

The realization of actions determined in the Roadmap necessitates joint activities with stakeholders, including public institutions.

Overview of the banking system

In 2022 main banking sector indicators followed positive trends. Quality of and return on assets and liquidity indicators were favorable, the capital position met prudential requirements. The regulatory policy implemented and the current supervisory framework provided stable performance of the banking sector. 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. Since the country's financial infrastructure is bank-centered, the banking system discharges the main financial intermediary function in financing of the economy. The bank assets to GDP ratio (one of the main indicators to characterize financial depth of the banking sector) is 35.2%. At the same time, another financial depth indicator – the lending portfolio to GDP ratio is 14.6% (the lending portfolio to non-oil GDP is 28%). Financial depth indicators of the Azerbaijani banking sector is lower than in benchmark countries, expressive of future growth potential of the banking sector.

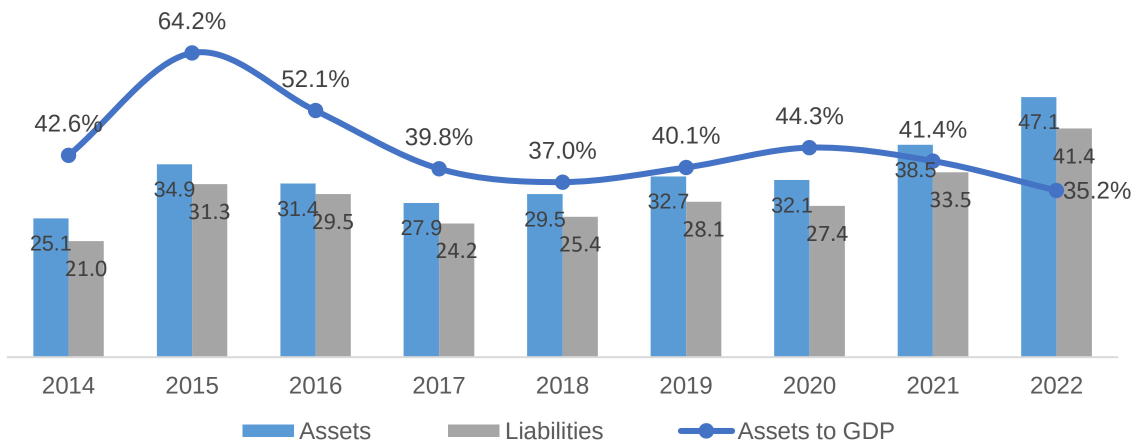
There are 25 banks in the country, two of which are state-owned banks. The number of banks with foreign capital is 11, and there is a local branch of one foreign bank. The service network of the sector includes 487 branches, 91 divisions, 2997 ATMs, and 22.8 thousand employees. The number of branches per 1000 km^2 territory is 6, the number of ATMs per 100 thousand persons is 29. The service network has not expanded considerably year over year (branch network increased by 2%, the number of ATMs increased by 3%), 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***

The balance of the banking sector jumped amid high economic activity and wider resource base of banks. Bank assets increased by 22% (AZN8.6B) to AZN47.1B, while liabilities increased by 24% (AZN7.9B) to AZN41.4B. As of end-2022, bank assets consist of net lending portfolio (39%), liquid assets (37%), deposits placed with and loans of financial institutions (11%) and other assets (13%). Bank liabilities mainly include deposits of legal entities. Deposits of legal entities account for 54%, deposits of individuals for 28%, due to financial institutions for 12% and other liabilities for 6% of total liabilities.

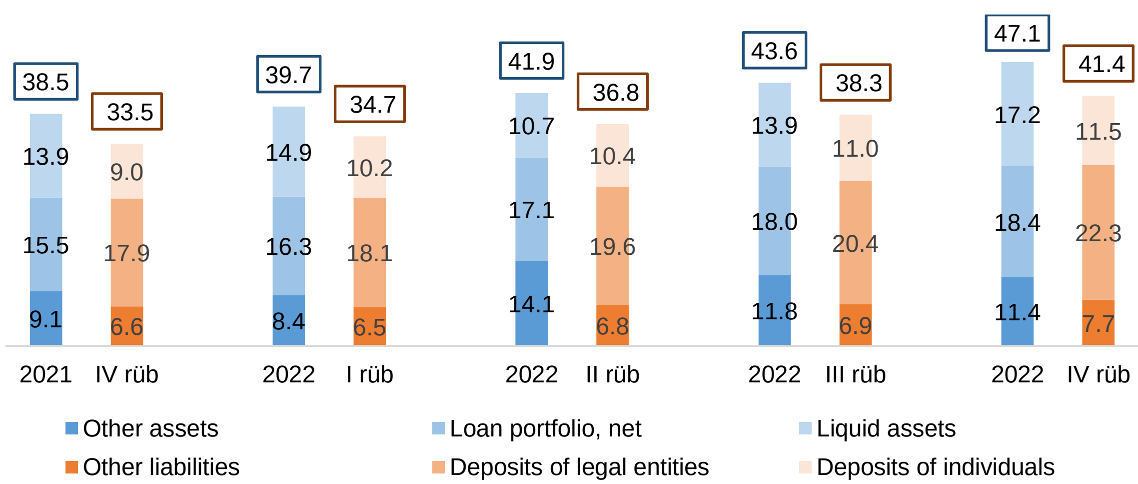
Expansion of banking sector assets kept pace with stable growth of liabilities amid rising economic activity. The dynamics of resources attracted by the banking sector was supported by the rise in deposits of legal entities resulting in the rise in cashless operations with the economy being more transparent and the main indicator of confidence in the banking system – deposits of individuals. Deposits of legal entities increased by 24% and deposits of individuals increased by 27%.

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



Source: CBA

Chart 10. Dynamics of the structure of banking system assets and liabilities, bln.AZN

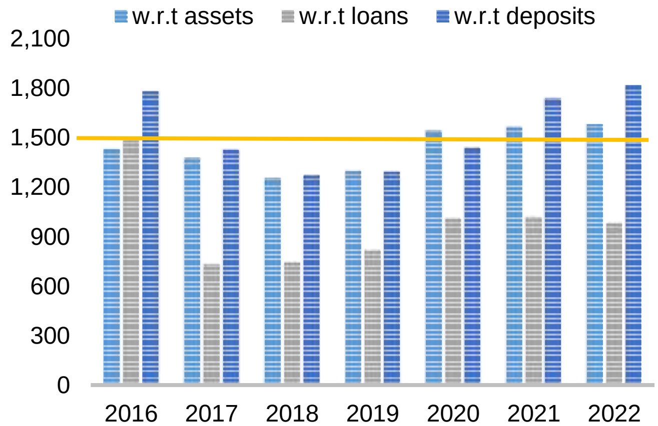


Source: CBA

- ***Banking system concentration***

Banking system concentration is increasing in Azerbaijan. The HHI[2] widely used in international practice shows that concentration on assets and deposits increased and on loans decreased over recent years. However, as of end-2022 banking sector concentration was medium on assets and deposits (1584 and 1819 respectively) and low on the lending portfolio (982).

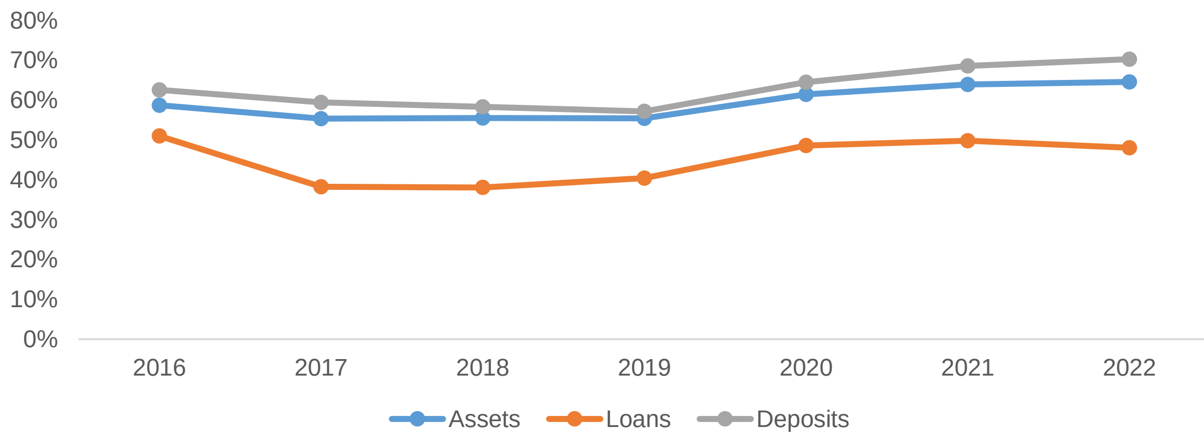
Chart 11. HHI index



Source: CBA

The dynamics of the market share of the largest three banks displays that concentration increased over recent years. The market share of the largest three banks on assets increased by 9 pp to 65%, the market share on the deposit portfolio increased by 13 pp to 70% and the market share on the lending portfolio increased 8 pp to 48% compared with 2019. The rise in banking sector concentration over recent 3 years has been kept on focus.

Chart 12. Dynamics of the market share of top three banks



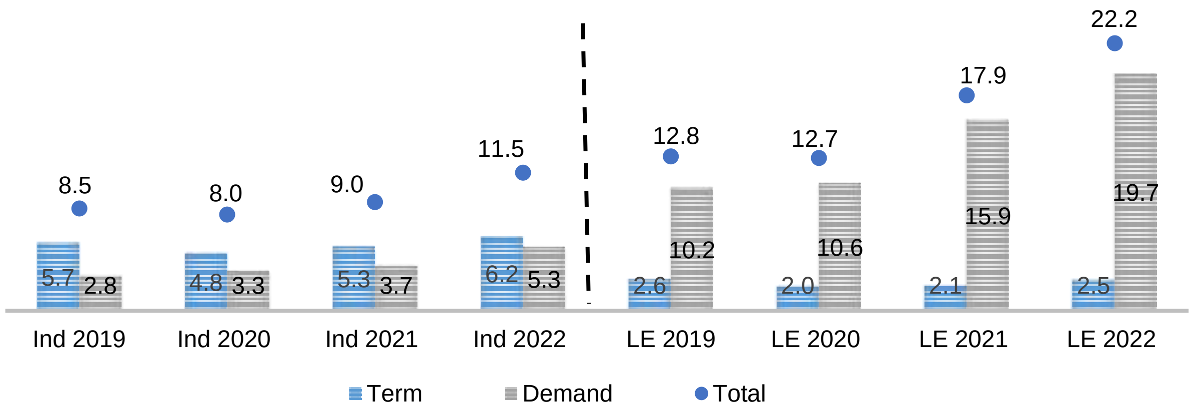
Source: CBA

[2] *The HHI is used in international practice to measure competitiveness and concentration in markets. According to the practice of the US Department of Justice, markets are divided into 3 parts on the basis of this index: lowly (HHI<1500), moderately (1500<HHI<2500) and highly (HHI>2500) concentrated markets. The value of the HHI may range between 0-10000.*

- ***Resources attracted on the banking sector***

Deposits of legal entities and individuals are playing a lead role in financing of the banking system. The deposit portfolio increased by 25.1% (AZN6.8B) to AZN33.8B. The deposit portfolio accounts for 81.5% of banking sector liabilities. The deposit portfolio consists of deposits of legal entities (66% or AZN22.3B) and those of individuals (34%, AZN11.5B). The deposit portfolio is mainly driven by demand deposits (74% of portfolio). A high share of demand deposits in financing of the banking system urges to maintain a large size liquidity buffer.

Chart 13. Dynamics of the deposit portfolio of individuals and legal entities, billion AZN



Source: CBA

Current liabilities, in particular deposits of legal entities act as the main source of financing. Deposits of legal entities account for 53.8% of total liabilities. Deposits of legal entities increased by 24.4% (AZN4.4B) to AZN22.3B, attributable to the rise in demand deposits (up by AZN3.85B). Demand deposits account for 88.4% (AZN19.7B) of deposits of legal entities. Deposits of large state companies, and companies engaged in the non-oil and gas sector, constitute the major part of demand deposits. The Bank pays attention to high concentration of demand deposits of legal entities.

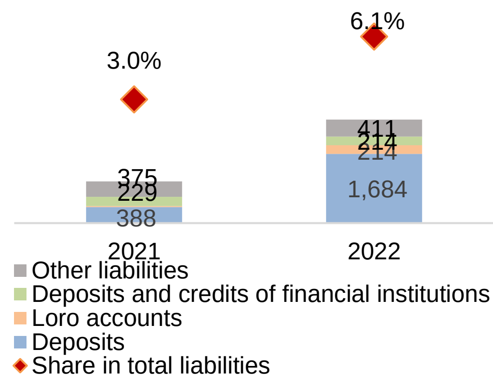
Dynamics in the deposit portfolio of individuals continues. The deposit portfolio of individuals increased by 27.1% (AZN2.45B) to AZN11.5B (historical high). Term deposits accounted for 54% (AZN6.2B) and demand deposits for 46% (AZN5.3B) of the deposit portfolio of individuals. The rise in the deposit portfolio is driven by demand deposits of individuals. Demand deposits of individuals increased by 43% (AZN1.6B), and term deposits increased by 16% (AZN0.9B). High dynamics of cashless operations of individuals, including debit card operations factored in the growth of demand deposits. Presently, deposits of individuals account for 27.7% of banking sector liabilities. Foreign currency denominated deposits continued to decrease year over year – dollarization of deposits of individuals decreased by 1.9 pp to 39.8%. Dollarization of term deposits of individuals fell considerably (by 5.6 pp to 39%), to be attributable to high confidence of the population in the financial system and the national currency.

The share of non-residents in banking sector liabilities increases.

Liabilities of the banking sector due to non-residents yoy increased by 2.5 times (AZN1.5B) to AZN2.5B. The share of liabilities due to non-residents in total liabilities increased by 3.1. pp to 6.1%, driven by the deposit portfolio (AZN1.3B) and Loro accounts (AZN0.2B).

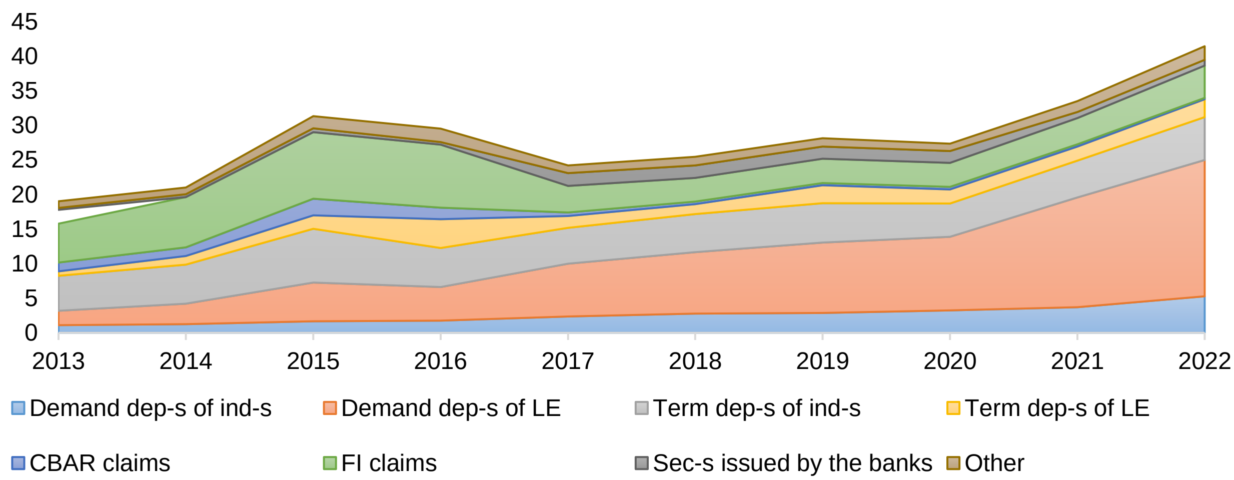
Note that, the share of non-residents in the deposit portfolio increased to 5% from 1.4%.

Chart 14. Dynamics of resources attracted from non-residents, million AZN



Source: CBA

Chart 15. Dynamics of the structure of funds attracted across the banking sector, billion AZN



Source: CBA

Composition and term structure of liabilities contains creation of long-term assets. Whereas maturity of most business and consumer loans is up to 5 years, deposits are placed from 1 to 3 years. Moreover, demand deposits account for 60% of the deposit portfolio, forcing banks to maintain large size liquidity and containing long-term financing of the economy by banks.

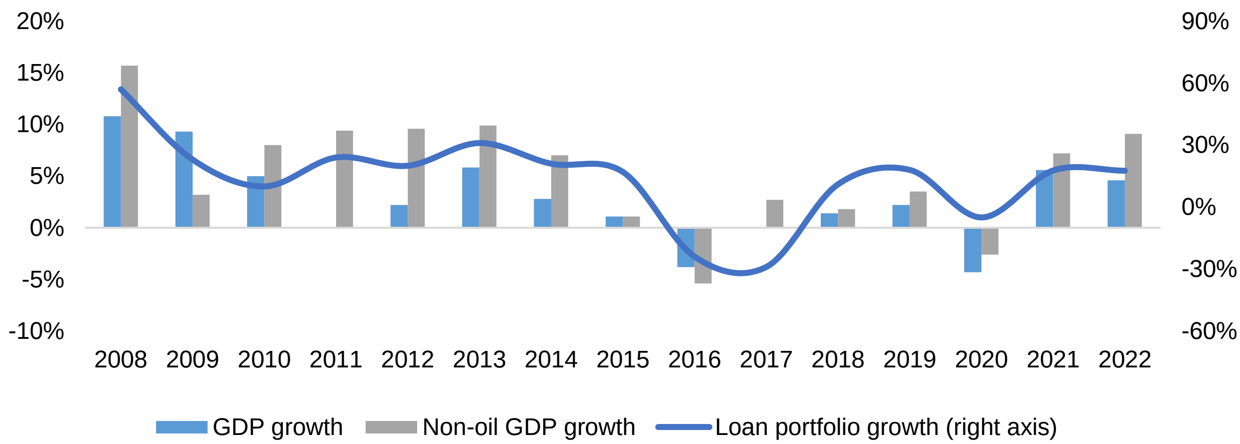
Chart 16. Term structure of assets and liabilities

Source: CBA

- ***Bank lending***

The lending portfolio kept increasing. The lending portfolio increased by 17.6% (AZN2.9B) to AZN19.6B. There is a high correlation between the dynamics of the lending portfolio and economic activity.

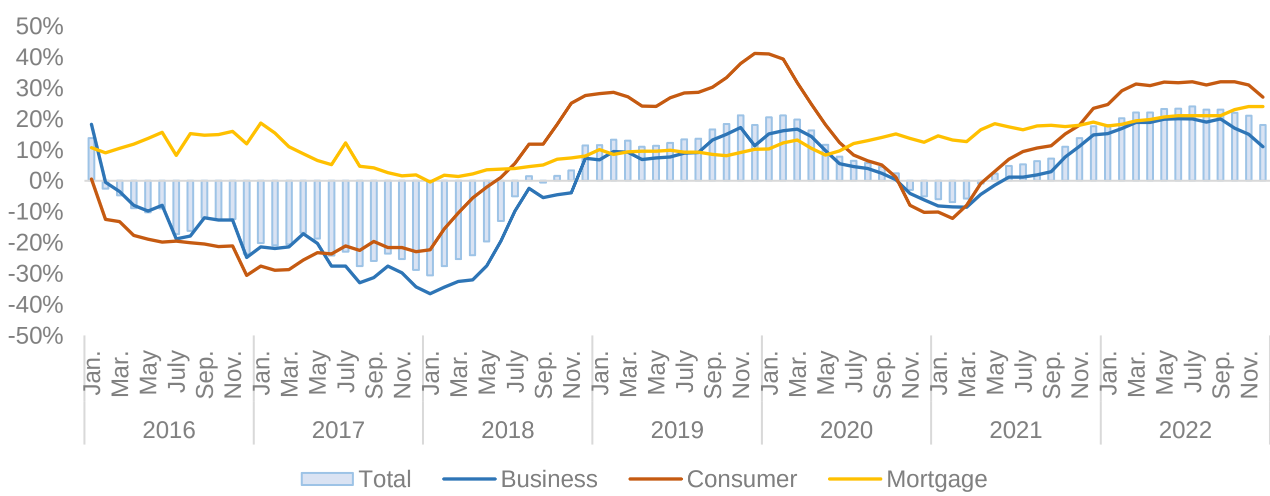
Chart 17. Comparison of the growth rate of the lending portfolio and GDP



Source: CBA

In 2022 the lending rate peaked after the pandemic and started to stabilize. In July 2022 tightening on consumer loans and easing on mortgage loans in the regulatory framework contributed to the drop in consumer loans and rise in mortgage loans. The growth rate of the business portfolio also fell amid slowdown in the economic growth rate.

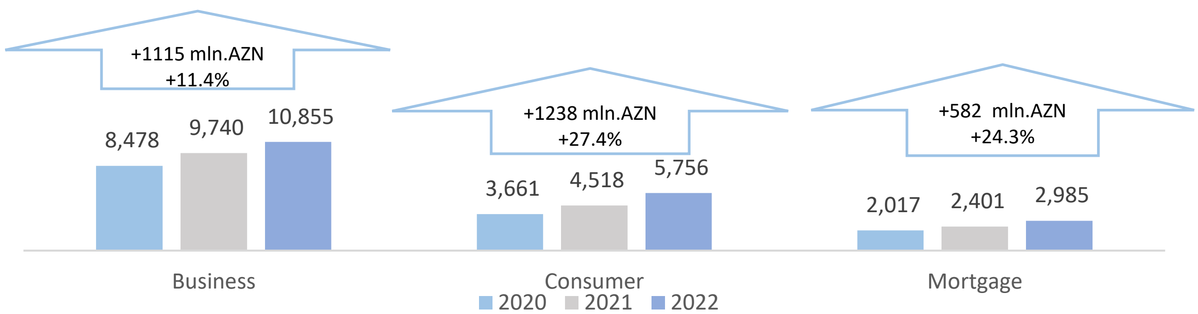
Chart 18. Comparison of annual growth rate of the lending portfolio



Source: CBA

In general, business loans increased by 11.4% (AZN1.1B) to AZN10.9B. The mortgage portfolio increased by 24.3% (AZN584M) to AZN3B, driven by the state mortgage program. The consumer-lending portfolio increased by 27.3% (AZN1.2B) to AZN5.8B.

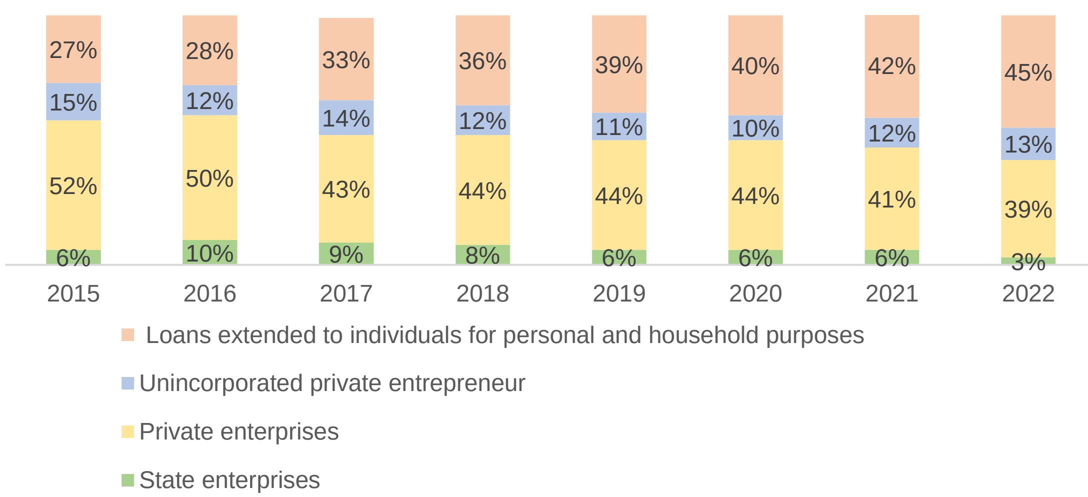
Chart 19. Dynamics of the lending portfolio, million AZN



Source: CBA

The CBA keeps in mind growth dynamics of the consumer portfolio. The implemented macro prudential policy was oriented towards moving consumer lending to stable and healthy horizon and new changes were made to the prudential framework to that end (See: Box - A new macro prudential framework on consumer loans).

Chart 20. Dynamics of borrower structure of the lending portfolio

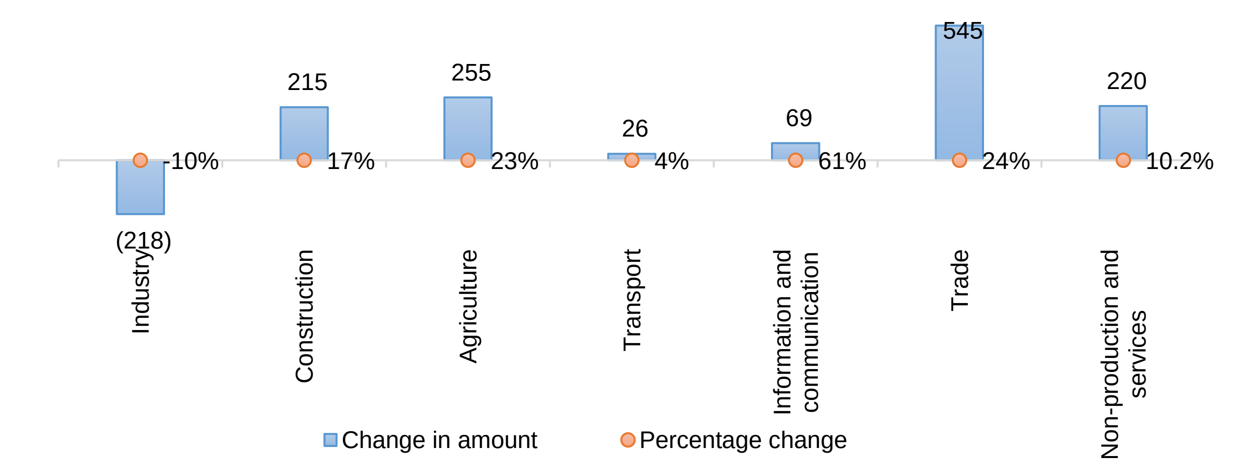


Source: CBA

In 2022 the business loans portfolio expanded on the backdrop of demand. Business loans increased by AZN1.1B to AZN10.9B (55% of total lending portfolio). Loans to trade and services have the highest share in the business portfolio (48% of total business portfolio). All areas of the business portfolio posted growth except for loans to the industry. The business portfolio was driven by loans to trade (AZN545M), agriculture (AZN255M), and services and non-production (AZN220M).

The CBA provide promotional regulatory initiatives to support credit investments to the real sector of the economy. A dedicated regulatory framework was shaped to regulate loans issued to finance large-scale and long-term projects. Moreover, the pressure of loans to the real sector on bank capital was eased (introduction of the 'Standard assets exposed to additional risks' category), aided by the opportunity to re-channel resulting funds to lending to the real sector.

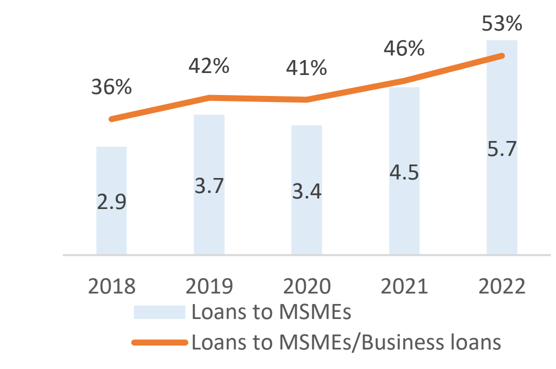
Chart 21. Annual dynamics of the business portfolio, million AZN



Source: CBA

Growth in loans to micro, small and medium sized entities continued. Loans to MSMEs increased by 28% to AZN5.7B compared to early year. As a result, the share of loans to MSMEs in the business portfolio exceeded 50%, owing to the easing of standards on MSMEs.

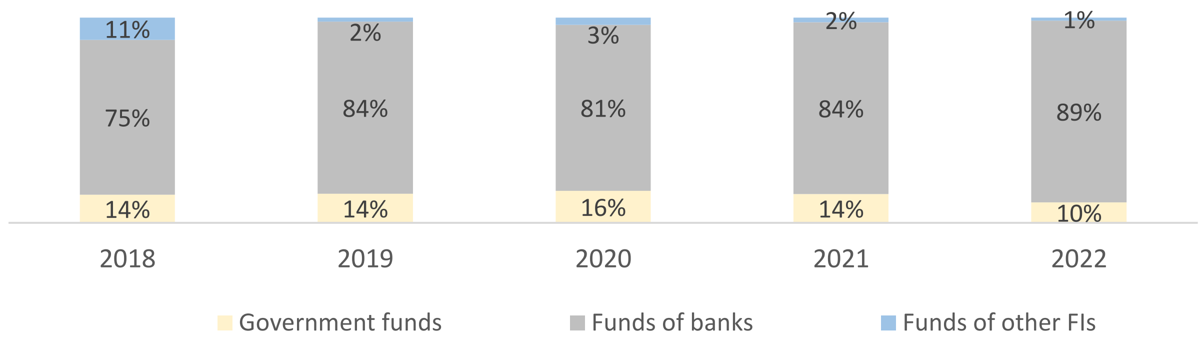
Chart 22. Dynamics of loans to MSMEs, billion AZN



Source: CBA

The share of banks' own funds in MSME lending is increasing. Banks have been actively participating in MSME lending at the expense of their own funds. Loans issued from banks' own funds since early 2022 have increased by 35% (AZN1.3B) to AZN5B. As a result, the share of loans to MSMEs from banks' own funds increased by 5 pp to 89%. Activity directions on promotion of MSME awareness options and expansion of access to finance were included to the 'Strategy of socio-economic development of the Republic of Azerbaijan in 2022-2026'.

Chart 23. Structure of loans to MSMEs in terms of funding sources



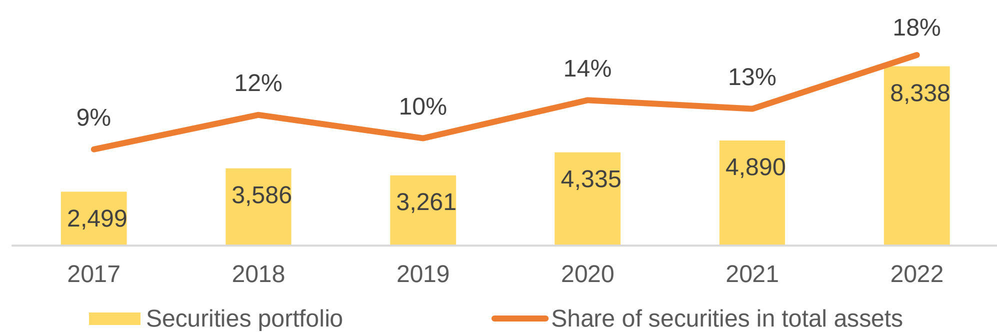
Source: CBA

- **The securities portfolio**

Significance of securities as an investment tool is elevating. Over the reporting year the value of securities increased by 71% to AZN8.3B and the share in total assets increased by 5 pp to 18%. The liquidity position of the sector, rise in the issuance of government securities (GSs) and the new monetary policy framework of the CBA contribute to the growth of the securities portfolio. Azerbaijan accounts for 76%, the USA for 20% and other countries for 4% of the securities portfolio.

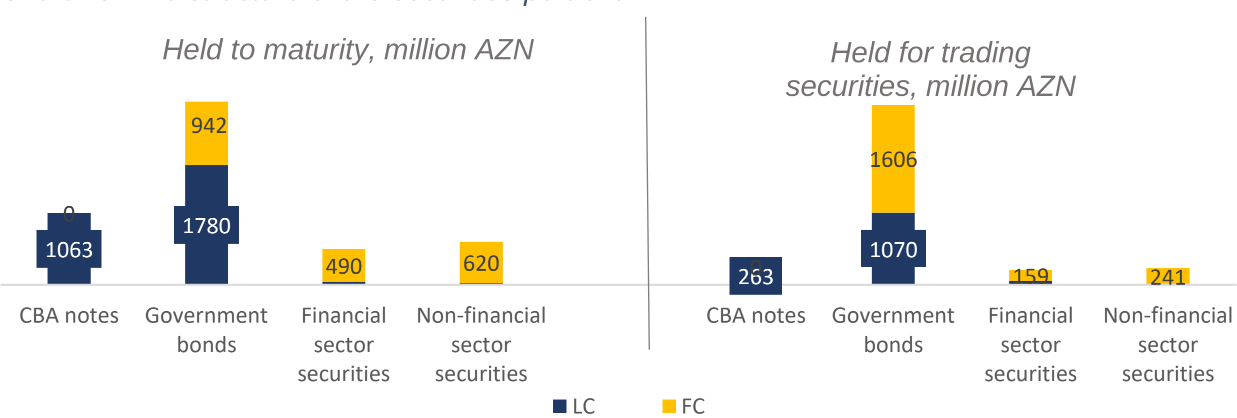
Government bonds drive the securities portfolio (64.8% of total securities). National currency denominated securities prevail in the held-to-maturity government bonds and foreign currency denominated securities prevail in the trade portfolio.

Chart 24. Dynamics of the securities portfolio, million AZN



Source: CBA

Chart 25. The structure of the securities portfolio

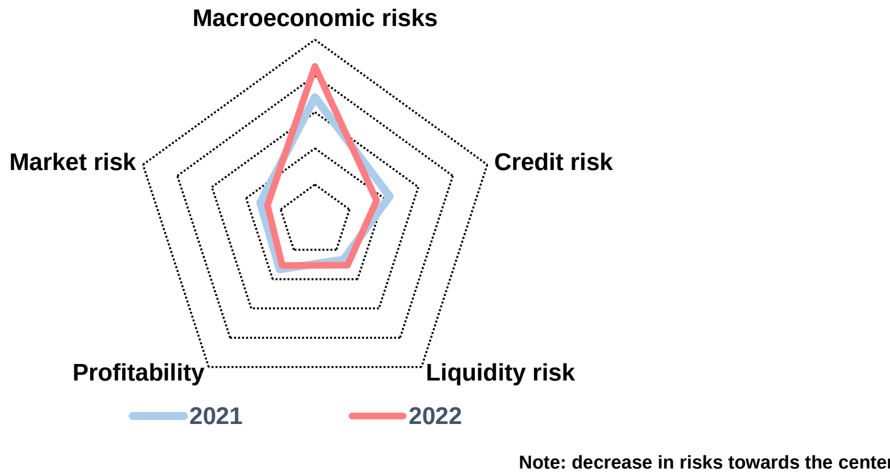


Source: CBA

The national currency accounts for 51.5% and the foreign currency for 48.5% of the securities portfolio. The main reason for prevalence of national currency denominated securities is in CBA notes and government bonds. Major part of securities across financial and non-financial sectors is in a foreign currency.

- ***The balance of risks of the banking sector improved.***

Chart 26. The risk mapping of the banking sector



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:

Although positive dynamics in the quality of assets and write-offs on the loss loan portfolio contribute to the improvement in the quality of the lending portfolio, sensitivity zones remain. The Bank keeps on focus the quality of the portfolio, the provisioning level and the restructured portfolio.

Profitability position:

The banking sector that operates under complicated macroeconomic circumstances maintained its profitability. The Bank keeps on focus equal distribution of profitability across the sector and the growth rate of non-interest expenses.

Market risks:

Reduction in the open currency position (OCP) resulting from resolving the structural problem on the banking sector and de-dollarization contributed to the drop in market risks.

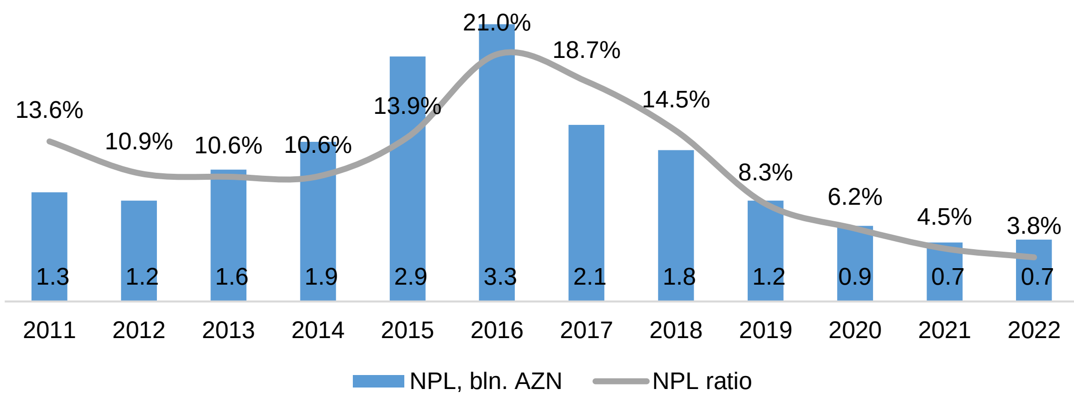
Liquidity risks:

Liquidity of the sector is in a comfort zone and fully meets prudential requirements. Initiatives continue to distribute liquidity homogenously across the sector. The new monetary policy operational framework supports optimum distribution of liquidity in the sector.

Credit risk of the banking system

The credit risk subdued. The NPL portfolio decreased by 1.8% to AZN0.7B. The share of NPLs in total portfolio decreased by 0.7 pp to 3.8%. At present, the NPL ratio is in historical lows. The drop in the NPL portfolio was also supported by write-offs of problem loans along with the improvement of the risk management framework in banks and positive dynamics in the payment behavior of borrowers. AZN180M worth loans were written off over the year (yoy AZN183M).

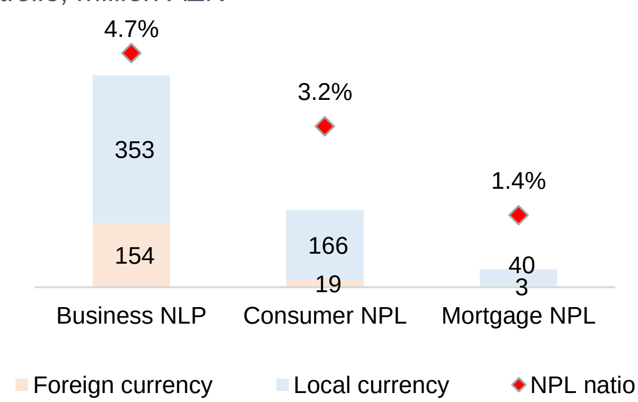
Chart 27. Dynamics of the NPL portfolio on the banking sector



Source: CBA

Business loans account for 69% (AZN0.5B), consumer loans for 25% (AZN0.2B) and mortgage loans for 6% (AZN0.04B) of the NPL portfolio. Whereas the NPL ratio is 4.7% on the business portfolio, this indicator is 3.2% and 1.5% on consumer and mortgage portfolio respectively. In general, national currency denominated loans account for 76% and foreign currency denominated loans for 24% of the NPL portfolio.

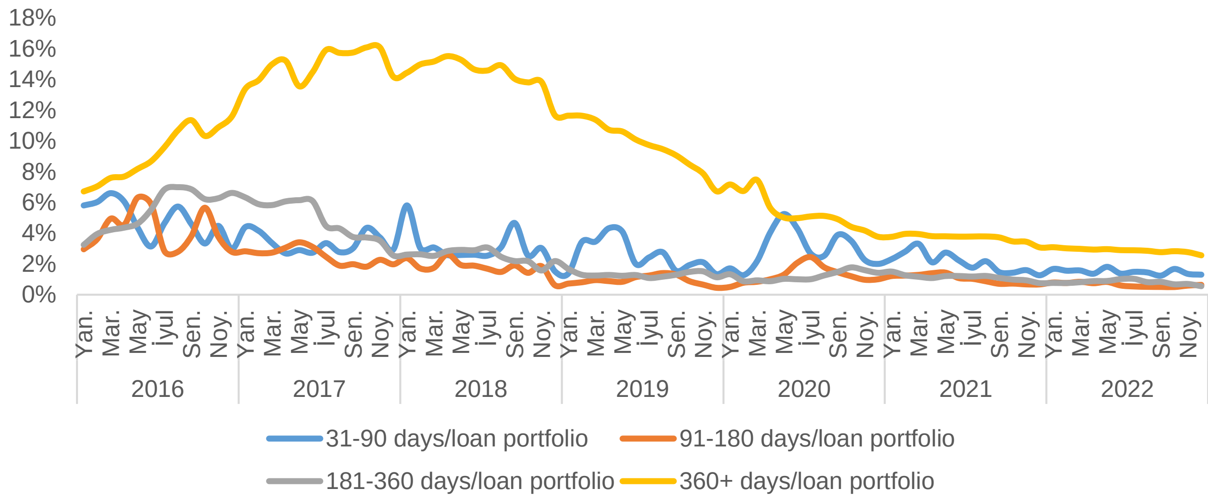
Chart 28. Sectorial and currency structure of the NPL portfolio, million AZN



Source: CBA

The dynamics of the structure of the NPL portfolio on delinquency also displays that credit risks subdued. The share of over 1 year delinquent NPLs in the portfolio has decreased by 11.6 pp from 14.2% to 2.6% since 2017 (3.1% as of end-2021).

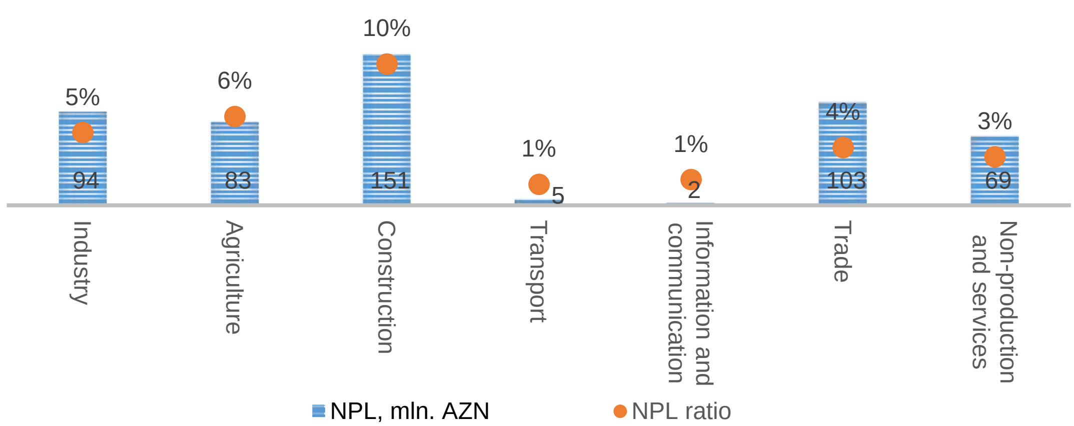
Chart 29. Breakdown of the lending portfolio by delinquency



Source: CBA

There was a considerable change in credit risks on the business portfolio. The NPL ratio on the business portfolio decreased by 0.5 pp to 4.7% over the year. The value of NPLs on the business portfolio stands at AZN507M. NPLs on the business portfolio are concentrated mainly on construction and trade (50% of total NPLs on the business portfolio). NPLs on trade account for 10% of total business loans.

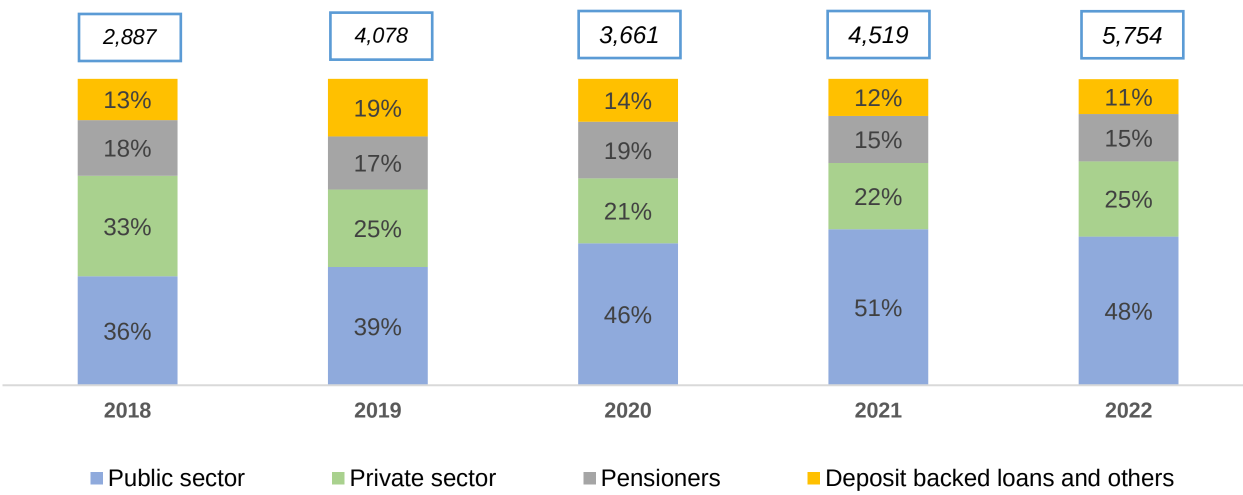
Chart 30. The NPL portfolio structure on economic areas



Source: CBA

There was not a considerable change in the NPL ratio on the consumer portfolio. In 2022 the NPL ratio on the consumer portfolio decreased by 0.8 pp to 3.2%. The consumer NPL makes AZN185M. 48% of consumer loans was issued to persons with fixed income engaged in the public sector. As of end 2018, this indicator was 36%. Lending of those engaged in the private sector recovered the pre-pandemic level and reached 25%. The share of loans to pensioners, a more vulnerable category, in total consumer portfolio remained unchanged (15%).

Chart 31. Structure of borrowers on the consumer portfolio, in percentage



Source: CBA

The prudential framework on consumer loans was tightened in July 2022 to provide sound and responsible borrowing and protect the sector from potential threats.[3] Risk weights on the DTI ratio and consumer loans with higher interest rates were increased under new regulatory changes. In addition, the imperative limit on the cap of the DTI ratio on consumer loans was set at 70%. The maturity requirement of consumer loans, including restructured consumer loans was tightened as well. And to reduce risks related to consumer loans with a high (45%+) DTI, reserve requirements based upon the DTI ratio were tightened and restructured to the scope of requirement, the limit was increased and all consumer loans taken from that bank over recent 6 months were added.

Changes to the prudential framework had a positive effect on the DTI structure of the consumer portfolio. The share of consumer loans with over 45% DTI ratio decreased by 12 pp to 27% compared with July 2022. Loans issued on the 60%-70% DTI with additional risk weight applied decreased by 2 times over recent 6 months.

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[3] *Changes made to the 'Regulaition on creation of special reserves for asset classification and loan loss provisioning' and the 'Regulation on prurdential ratios and requirements related to credit risks, including large credit risks exposures'*

Chart 32. The DTI structure of the consumer portfolio as of July 2022

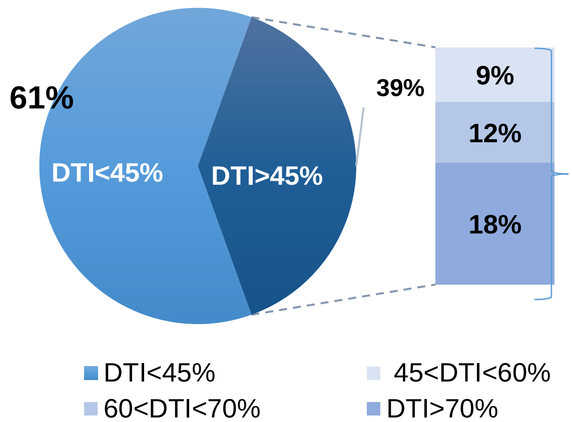
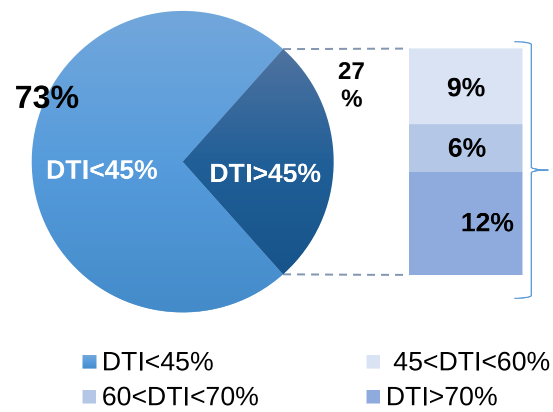


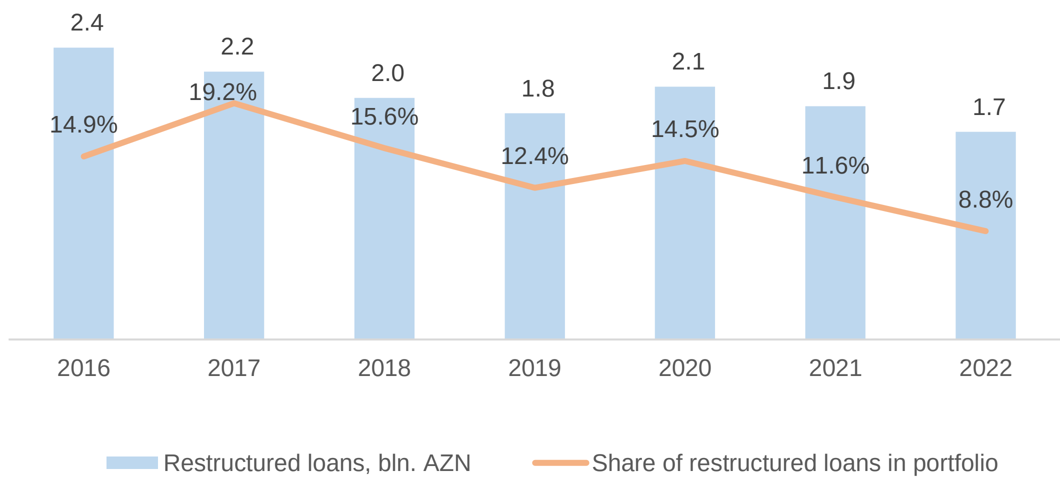
Chart 33. The DTI structure of the consumer portfolio as of December 2022



Source: CBA

NPLs on mortgage loans decreased. NPLs on the mortgage portfolio decreased by 35% (AZN23.2M) to AZN43M. As a result, the NPL ratio decreased by 1.3 pp to 1.4% as of end-year. The NPL ratio on loans issued from resources of the Azerbaijan Mortgage Loan and Credit Guarantee Fund (58% (AZN1.7B) merely 0.4%.

Chart 34. Dynamics of the restructured portfolio

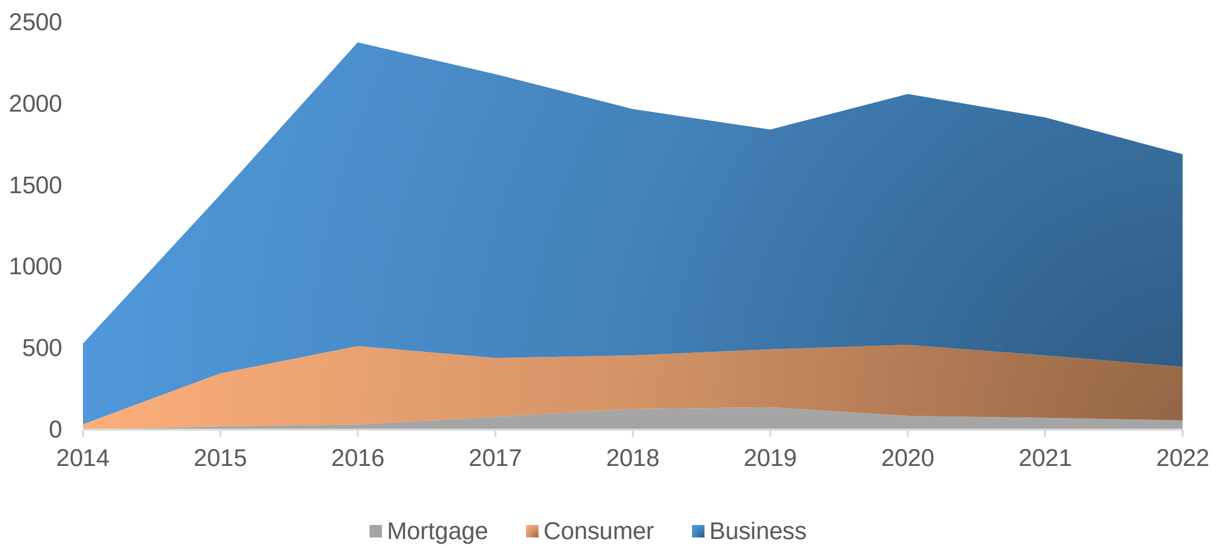


Source: CBA

Dynamics of the restructured portfolio decreased. In 2022 the restructured portfolio decreased by 12% (AZN224M) to AZN1.7B. The share of restructured loans in the total lending portfolio decreased by 2.9 pp to 8.6%, the lowest level of recent 8 years.

Restructured loans on the business portfolio amount to AZN1.3B, the three fourths of the total restructured portfolio. Restructured loans on the consumer portfolio amount to AZN329M and those on the mortgage portfolio amount to AZN56M. The restructured loans portfolio decreased across all three segments. In 2022, a new regulatory framework was shaped in 2022 to regulate risks on the restructured portfolio. A tighter reserve requirement was set on repeated restructuring of loans (the requirement to attribute the asset to a riskier classification category at each restructuring and higher loan loss provisioning).

Charter 35. Structure of the restructured portfolio, million AZN



Source: CBA

Box 2. A new macro prudential framework on consumer loans

A number of changes were made to the ‘Regulation on creation of special reserves for asset classification and loan loss provisioning’, the ‘Regulation on calculation of bank capital and its adequacy’ and the ‘Regulation on prudential ratios and requirements related to credit risks, including large credit risks exposures’ in 2022 to ensure responsible and sound lending in light of high activity in consumer lending, prevent excess indebtedness of the population and further strengthen financial resilience of the banking sector.

- ✓ **Under new changes with certain exceptions[4], the issue of loans with over the 70% (seventy) DTI ratio on consumer loans has been restricted.** Risk weights on consumer loans with the 45-70% DTI ratio have been tightened accordingly.

Risk weight of consumer loans based on DTI ratio

The DTI ratio	RWA	
	Before	After
45% < DTI ≤ 60%	150%	200%
60% < DTI ≤ 70%[5]	180%	230%

- ✓ **The maturity requirement of consumer loans, including restructured consumer loans have been tightened.** Under new changes, aggregate amount of all credit exposures on consumer loans with 5 year and over maturity should not exceed 0.1% of Tier I Capital after deductions.
- ✓ To ensure a reducing effect of new prudential requirements on consumer loans on interest rates **the ratio criteria and risk groups of consumer loans whose interest rate is higher than the average interest rate of the sector has been tightened.**

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[4] *Conditions for exceptions are as follows:*

1. in the event deposits (of the borrower or the third party) with the same bank act as securitization for national currency denominated consumer loans, if the LTD does not exceed 100%, if bank metals act as vault collateral to the bank over 90% and other precious metals over 70%;

2. in the event foreign currency denominated deposits (of the borrower or the third party) with the same bank, or bank metals pladged as collateral to tha bank act as securitization for foreign currency denominated consumer loans if the LTD ratio is not over 90%.The risk weight on determined exceptions is 200%.

[5] *The risk weight on consumer loans issued until the new changes take effect and whose DTI ratio is over 70% left unchanged at 200%.*

Risk weights on interest rates of consumer loans:

Old approach:	
Interest rate	**RWA**
Interest rate > average interest rate of the sector on consumer loans issued previous quarter *1.33	150%
Interest rate > average interest rate of the sector on consumer loans issued previous quarter *1.5	180%

New approach:	
Interest rate	**RWA**
Interest rate > average interest rate of the sector on consumer loans issued previous quarter *1.25	200%
Interest rate > average interest rate of the sector on consumer loans issued previous quarter *1.33	230%

✓ **The provisioning requirement on risky consumer loans have been tightened.** To ensure sound and responsible lending on consumer loans the DTI-based reserve requirements (if the DTI is over 45%, 25% reserve requirement) have been tightened on the following directions:

- **Restructured loans,** as well as **loans with limits increased** have been added to the scope of the requirement along with newly issued loans;
- The requirement has been applied to **all consumer loans** of the borrower **obtained** at the same bank **over recent 6 months**.

✓ The criteria on attributing loans **whose interest repayment periodicity is over 90 days** to the unsatisfactory category has been applied to **restructured** consumer loans under contractual conditions.

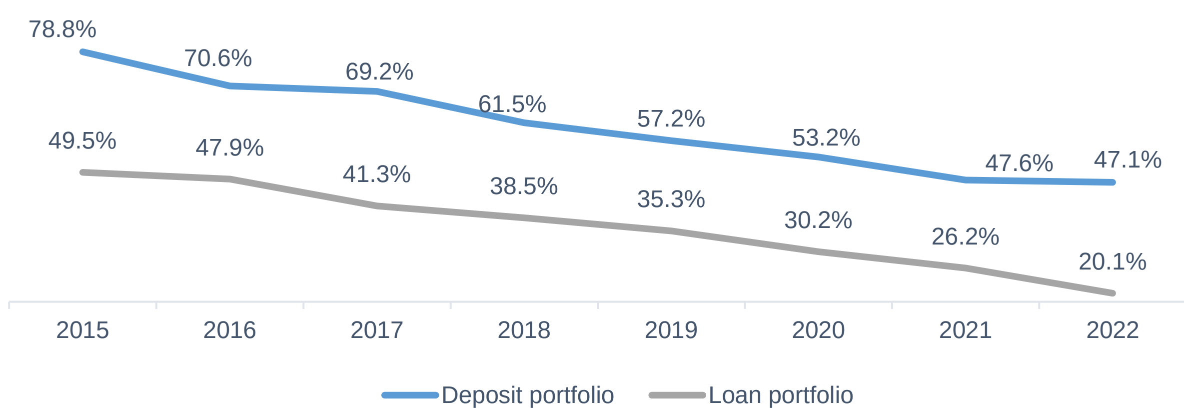
✓ At the same time, to ensure resilience of the banking sector to ecological, social and economic risks **the regulatory framework has been eased to stimulate the use of eco-friendly cars**. The limit on amount has been annulled, now the limit is applied on the production year.

Market risk of the banking system

The currency position of the banking sector is within prudential requirements. In 2022, the banking sector's long OCP made $143M, and the OCP to aggregate capital ratio stood at 4.7%. Note that, according to the 'Regulations on setting open currency position limits in banks', the cap on the aggregate OCP to aggregate capital ratio is 20% (on SDR).

De-dollarization continues in the sector. In 2022 dollarization of the deposit portfolio of the banking system yoy decreased by 0.5 pp to 47.1%, and dollarization of the lending portfolio decreased by 6.1 pp to 20.1%. Lower dollarization both allows neutralizing the effect of external shocks on and strengthens financial resilience of the banking system.

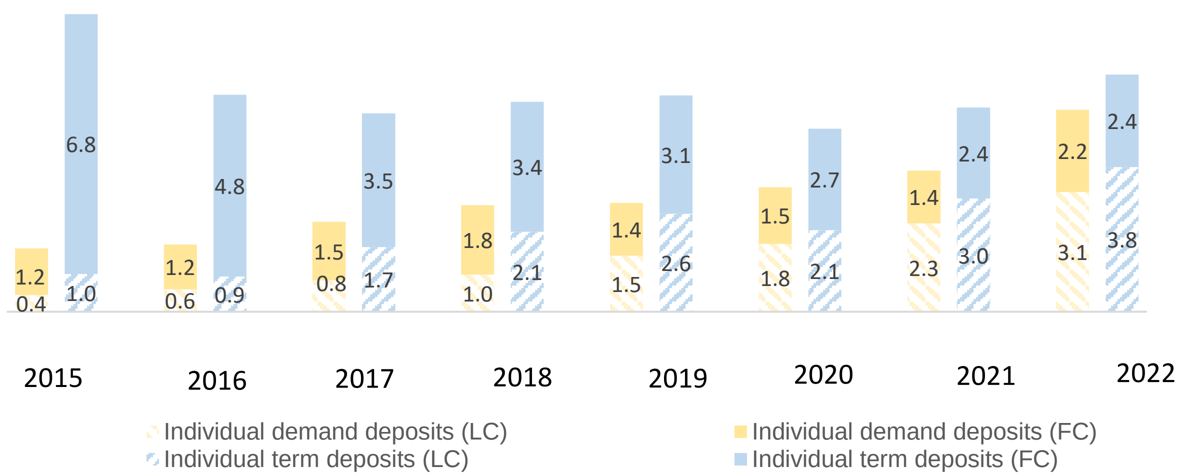
Chart 36. Dollarization of the portfolio



Source: CBA

In 2022, term deposits drove lower dollarization of deposits of individuals. Dollarization of total deposits of individuals decreased by 1.9 pp to 39.8%. Stability of the manat and high interest rates on national currency denominated deposits contribute to the rise in national currency denominated term deposits. Dollarization of term deposits decreased by 5.6 pp to 39%. Foreign currency denominated demand deposits of individuals increased year over year. Dollarization of demand deposits of individuals increased by 3.3 pp to 40.7%. The rise in demand deposits of individuals is attributable to deposits attracted from non-resident individuals.

Chart 37. Currency structure of the deposit portfolio of individuals, billion AZN

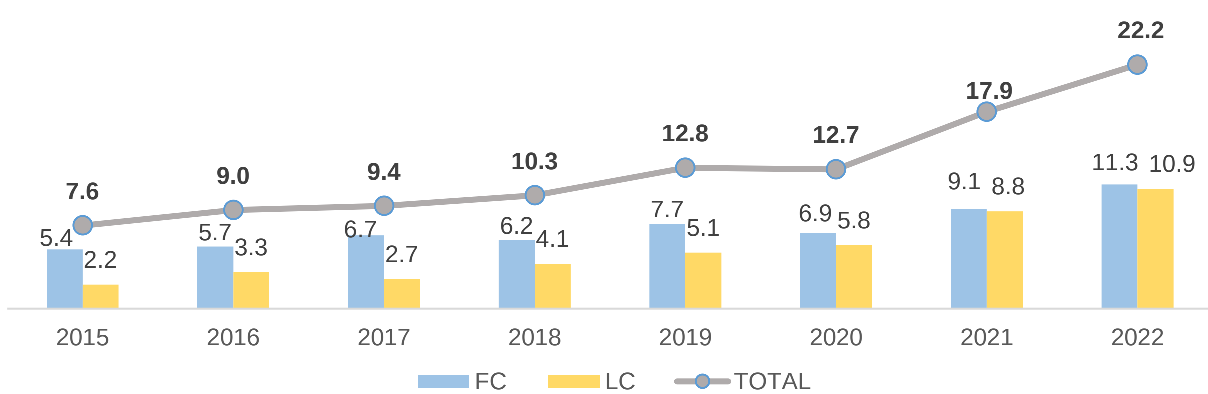


Source: CBA

Dollarization of deposits of legal entities was higher than that of individuals. Dollarization of total deposits of individuals has increased by 0.2 pp to 50.8% over recent 12 months, driven by demand deposits of legal entities; dollarization of demand deposits increased by 1.2 pp to 48.3%. In contrast, de-dollarization of term deposits of individuals continued – dollarization yoy decreased by 7.8 pp to 70.1%.

Foreign currency denominated deposits of legal entities are mainly concentrated in demand deposits, driven by oil companies.

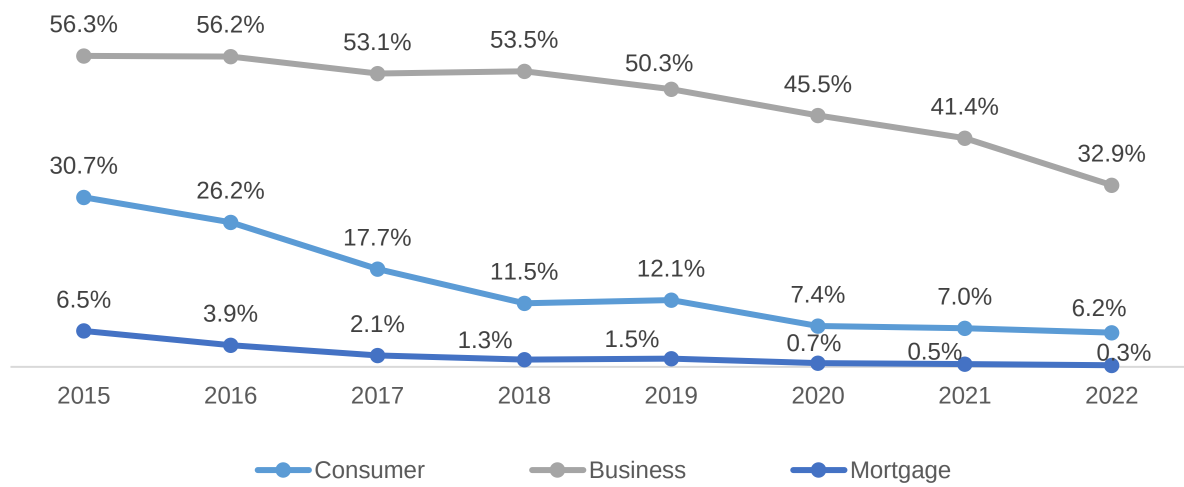
Chart 38. Currency breakdown of the deposit portfolio of legal entities, billion AZN



Source: CBA

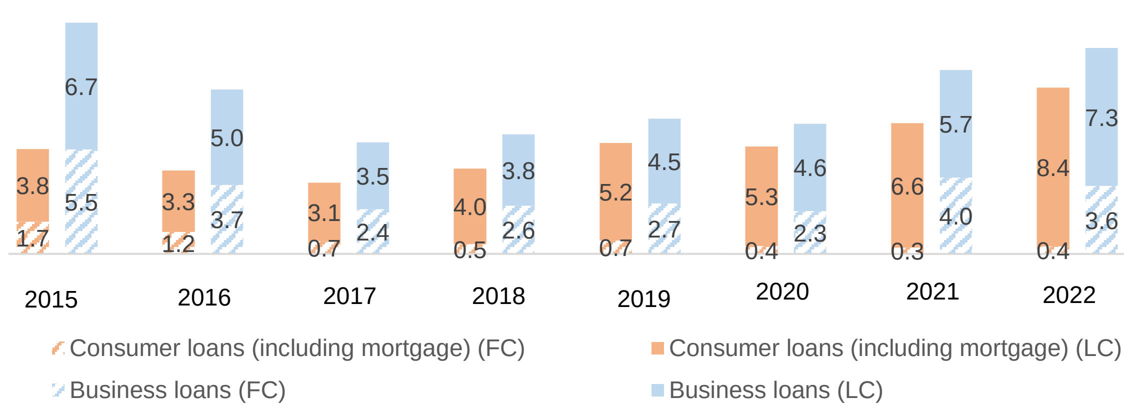
Dollarization is in historical lows across all segments of the lending portfolio. On the backdrop of the exchange rate stability of the manat and expansion of manat loans, the share of national currency denominated loans in the lending portfolio continued increasing. Dollarization of the overall lending portfolio decreased by 6.1 pp to 20.1%, driven by business loans – dollarization of business loans yoy decreased by 8.6 pp to 32.9%, the lowest level since 2015. At the same time, dollarization of consumer loans decreased by 0.8 pp to 6.2%, and that of mortgage loans decreased by 0.2 pp to 0.3%. Restriction of the issue of foreign currency denominated consumer loans to borrowers with no foreign currency income and setting of additional risk weights on foreign currency loans allowed the consumer portfolio dollarization to slump to historical lows. 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 almost in national currency.

Chart 39. Share of foreign currency in the lending portfolio



Source: CBA

Chart 40. Currency structure and dynamics of the lending portfolio, billion AZN



Source CBA

Banks' vulnerability to interest rates shelter their resilience. The interest rate risk was analyzed with the duration method[6]. Since most of assets and liabilities in the sector are recognized in their carrying value, calculations are carrying value based and discounted by the CBA interest rate. The main source of maturity mismatch between assets and liabilities is that the difference between the average weighted duration of loans and attracted deposits is about 4 times.

An increase in interest rates because of a positive duration difference has a downward effect on the capital adequacy ratio (CAR). According to simulations, a 1% rise in the interest rate decreases the CAR by only 1.0 pp that does not threaten the financial resilience of the banking system.

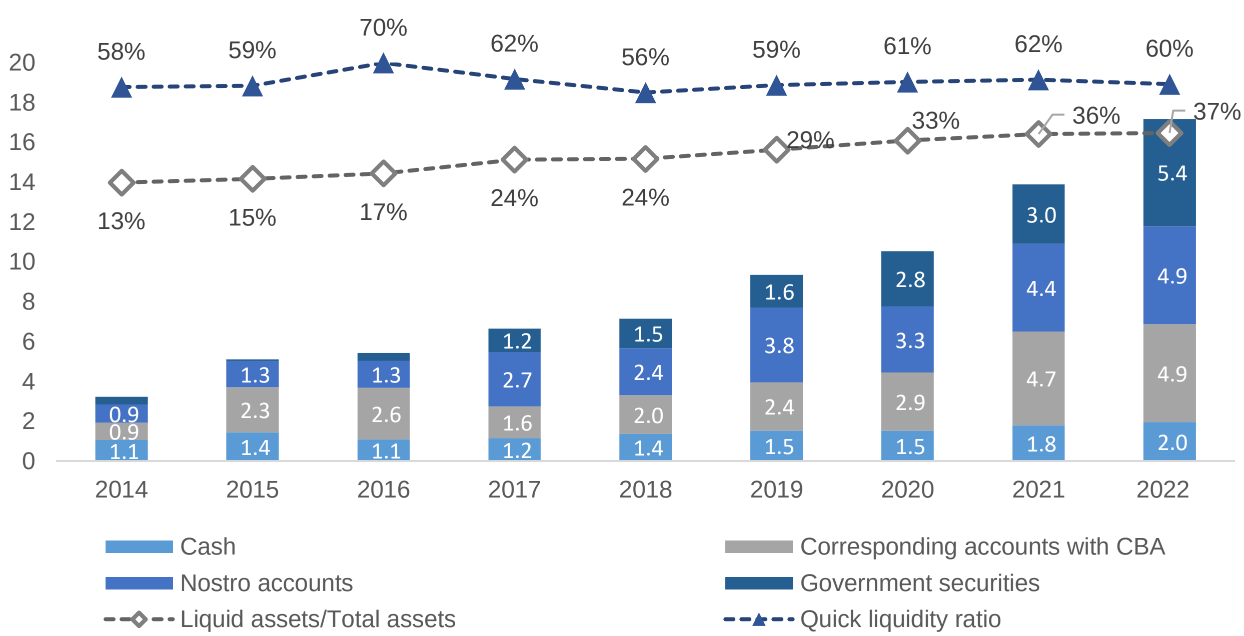
[6] *The duration analysis is used for measuring the weighted average term of assets and liabilities according to Macaulay duration concept. To remind, the duration gap analysis measures the sensitivity of banks to market interest rates with the following formula:*$\partial(asset) - \frac{\partial(liability)\times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

Liquidity risk of the banking system

Liquidity of the sector being in a comfort zone has an adequate buffer against foreign shocks. The instant liquidity ratio of the banking system (60%) exceeds the minimum requirement by two times (30%). Liquid funds account for 36.5% of assets, a higher indicator compared with benchmark countries.

Liquid assets are in historical highs. The size of liquid assets and their share in liquid assets continue increasing due to dynamic growth of current liabilities of the banking system. In 2022 liquid assets increased by 24% (AZN3.3B) to AZN17.2B. The share of liquid assets in total assets increased by 0.5 pp to 36.6%. Liquid assets are concentrated in GSs (31%), nostro accounts (29%), correspondent accounts with the CBA (29%) and cash funds (11.4%). Liquid assets of the banking system exceed demand deposits of individuals by more than thrice and cover 88% of demand deposits of legal entities.

Chart 41. Structure of liquid assets, billion AZN



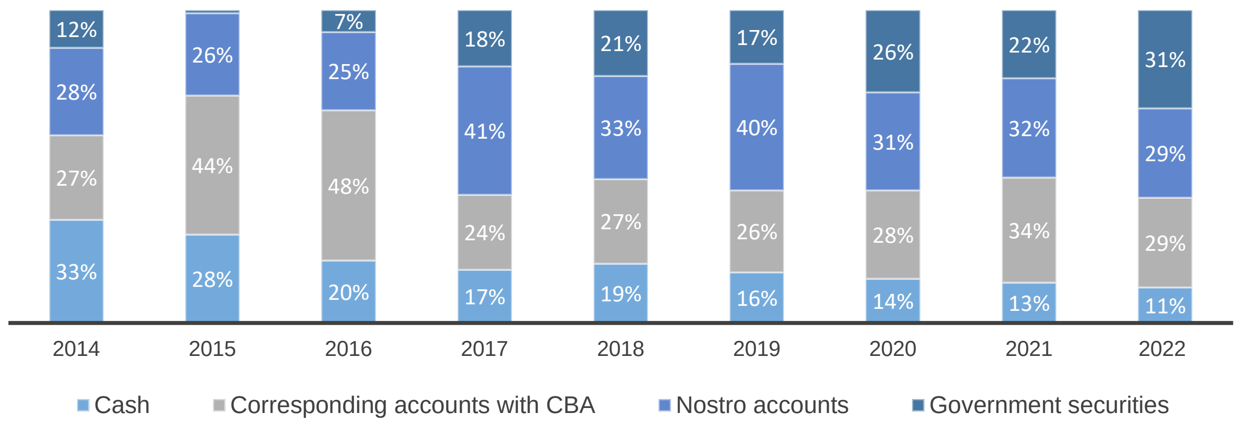
Source: CBA

On the backdrop of higher demand for securities as a short-term investment tool, the share of GSs in liquid assets increased. Over the year, the value of GSs held as a liquid assets increased by 81% to AZN5.4B and their share in liquid assets increased by 10 pp.

The share of liquid assets in foreign currency increased in the structure of liquid funds. Over the reporting year liquid assets in the national currency increased by 18.1%

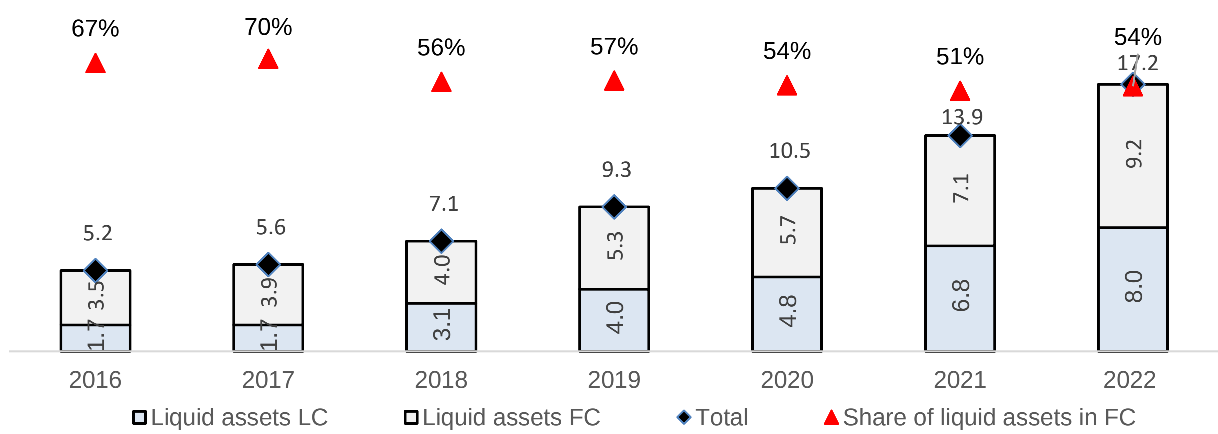
(AZN1.2B) to AZN8B. While liquid assets in a foreign currency yoy increased by 30% (AZN2.1B) to AZN9.2B, supported by demand deposits of individuals and legal entities.

Chart 42. The share of liquid asset components in liquid assets



Source: CBA

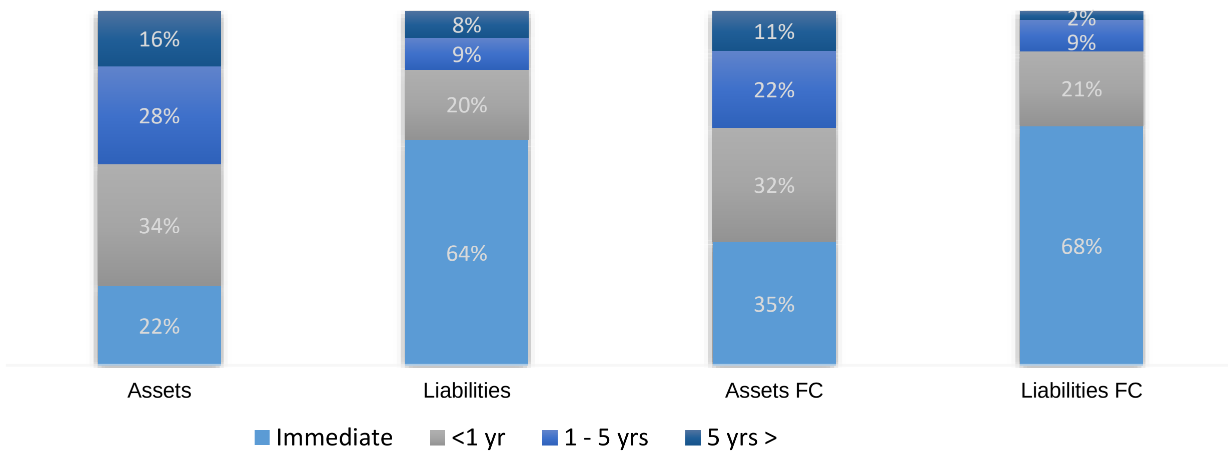
Chart 43. Currency structure of liquid assets, billion AZN



Source: CBA

The share of assets with up to 1 year maturity in total assets was 57%, that of liabilities was 84%. Maturity of 68% of liabilities being below 90 days contains long-term funding. Although the systematically increasing share of current liabilities in the balance sheet of the banking sector acts as a factor elevating maturity mismatch, it does not have a significant effect on the liquidity risk due to the sector's large liquidity buffer.

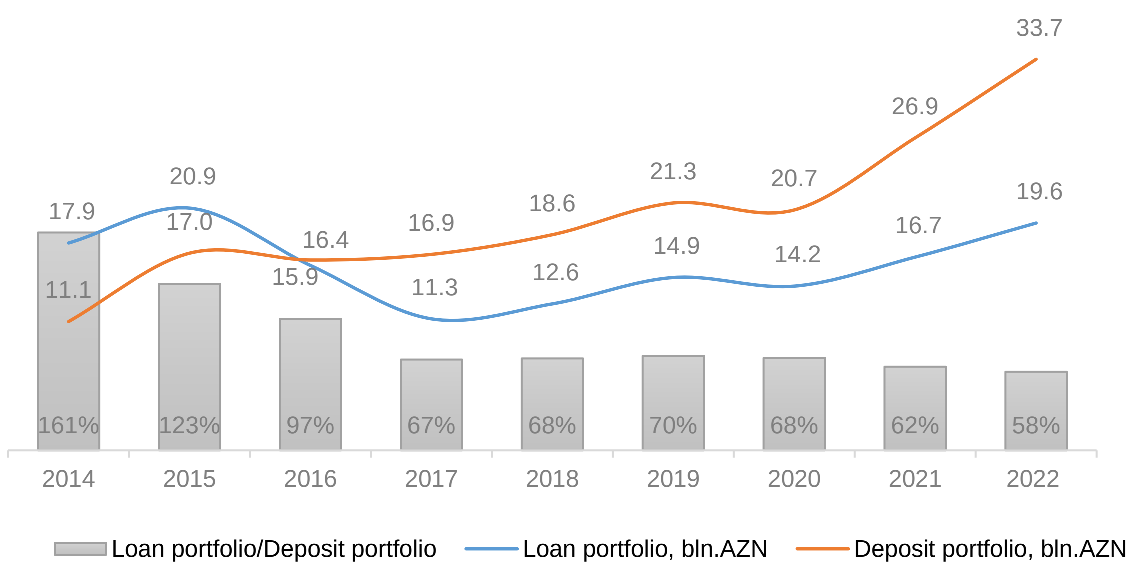
Chart 44. Maturity structure of assets and liabilities



Source: CBA

The dynamics of the loans to deposits ratio displays that banks have a resource basis for lending. In 2022 the credit portfolio to the deposit portfolio ratio yoy decreased by 3.8 pp to historical lows.

Chart 45. Dynamics of lending portfolio to the deposit portfolio

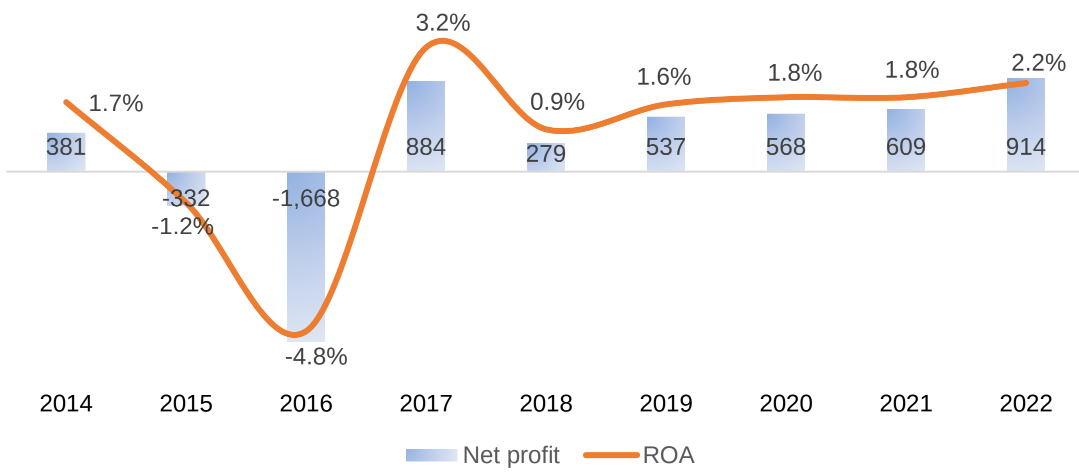


Source: CBA

Banking system profitability

Profitability indicators of the banking system are following a positive trend. In 2022 net profit of the banking system yoy increased by 50% (AZN305M) to AZN914M. Despite a complicated external environment and conditions, the banking system succeeded in increasing profitability.

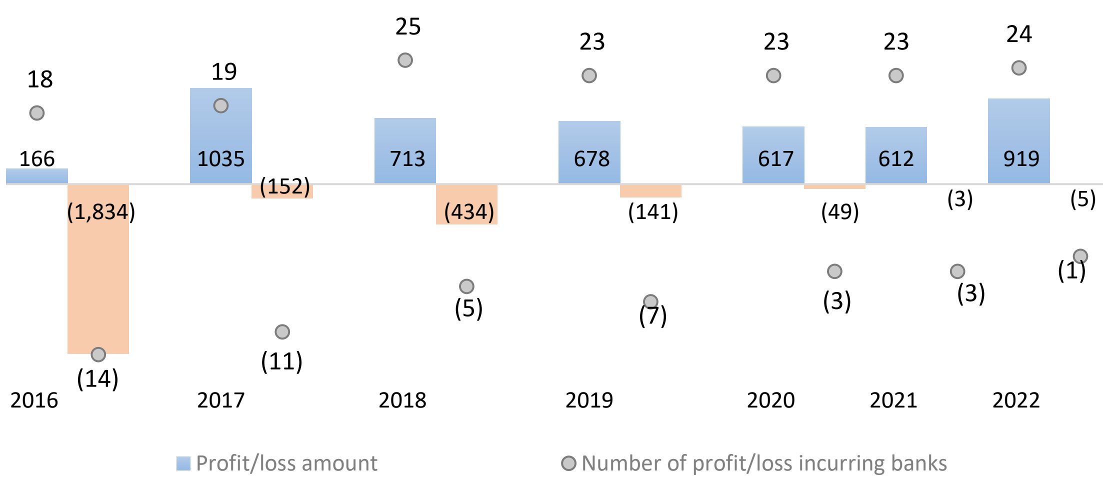
Chart 46. Banking system profitability, million AZN



Source: CBA

Profitability indicators across individual banks were also positive in 2022. Profit of 24 banks operating at a profit amounted to AZN919M, while loss of one bank operating at a loss was AZN5M. The number of banks operating at a loss has dropped from 7 to 1 over recent 4 years.

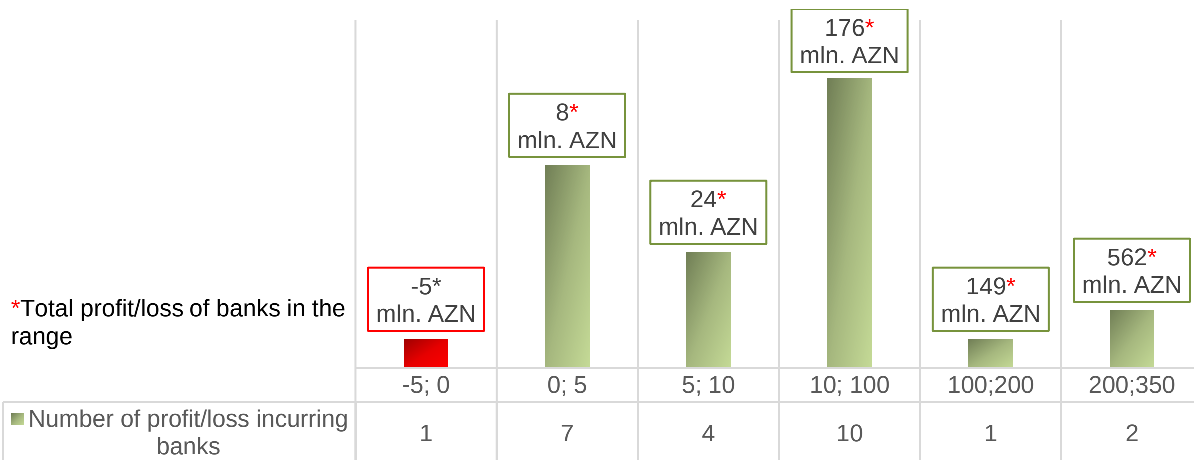
Chart 47. The number and dynamics of banks operating at a profit and loss, billion AZN



Source: CBA

Despite the rise in the number of banks operating at a profit, profitability is concentrated. 78% of net profit of the sector was concentrated in 3 banks that account for 65% of total banking sector assets.

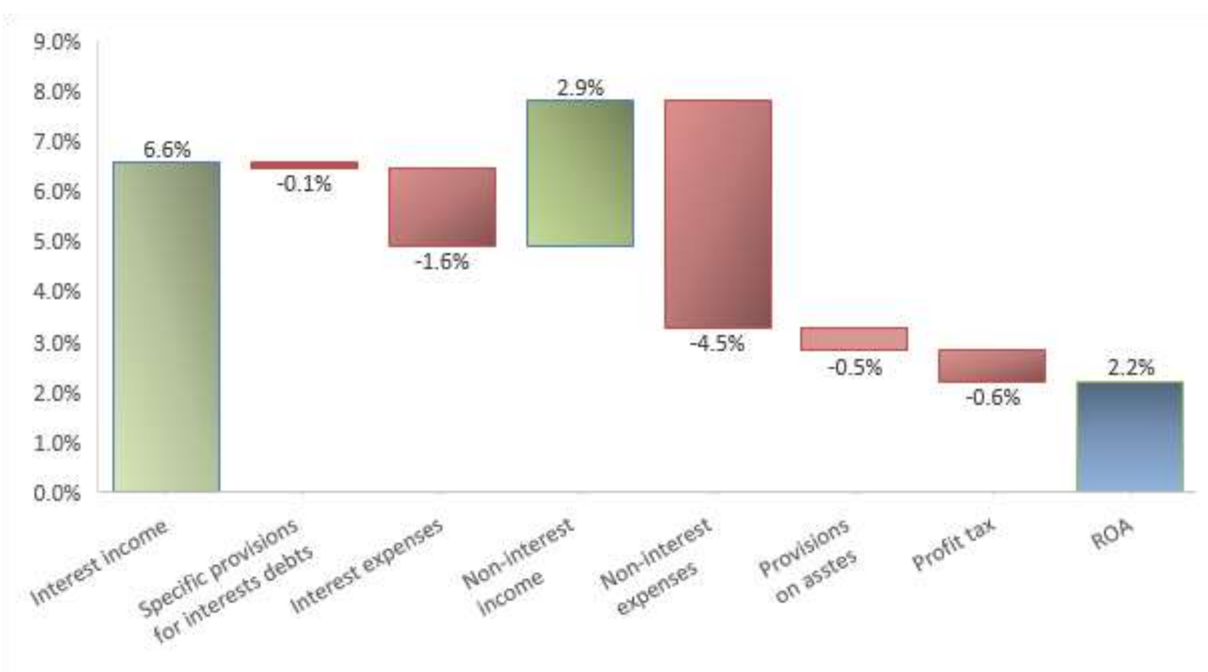
Chart 48. Profitability distribution in the banking system



Source: CBA

The ROA of the banking sector increased by 0.4 pp to 2.2%. As the main driver of return on assets interest income accounted for 6.6% of average assets. High non-interest expenses of the sector (4.5% of average assets) are compensated from interest and non-interest income.

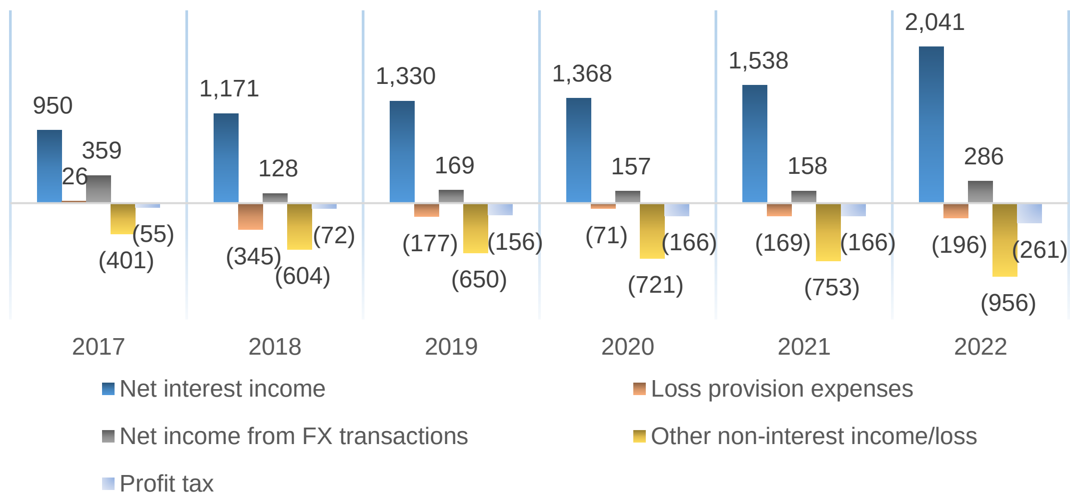
Chart 49. Decomposition of ROA



Source: CBA

Positive dynamics of net profit was driven by the rise in net interest income. AZN503M (32.7%) worth yoy rise in net interest income provided the rise in nominal profitability of the banking sector. As a result, profit margin increased by 2.7 pp to 23.1%.

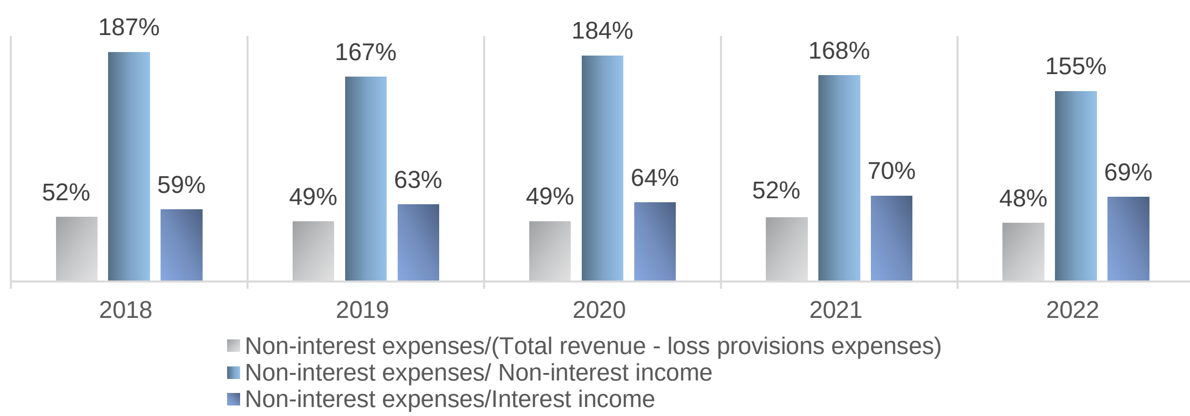
Chart 50. Decomposition and dynamics of profitability of the sector, billion AZN



Source: CBA

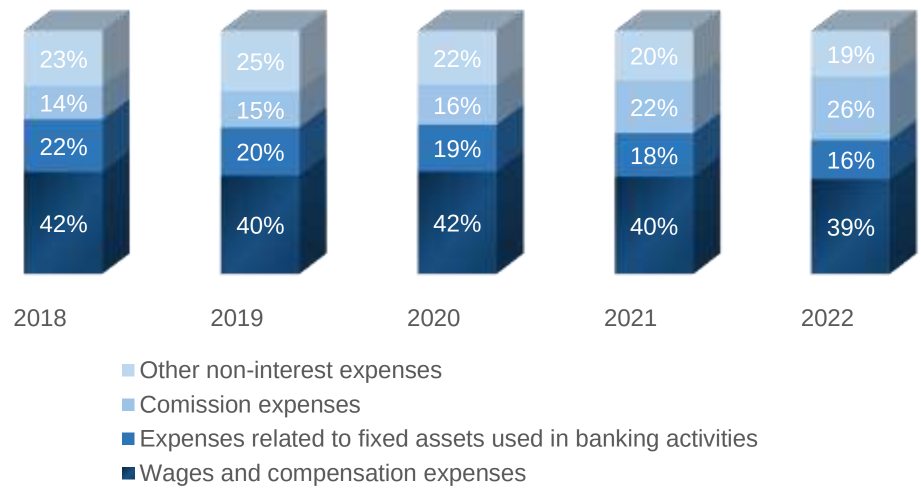
Efficiency indicators of the sector improved. Higher growth rate of interest and non-interest income compared to that of non-interest expenses contributed to the improvement of efficiency indicators. The non-interest expenses to interest income ratio yoy decreased by 13 pp to 155%. In general, non-interest expenses accounted for 48% of aggregate income in 2022, yoy down by 4 pp. Efficiency indicators improved due to the introduction of the scale effect and innovative solutions.

Chart 51. Efficiency indicators of the banking sector



Source: CBA

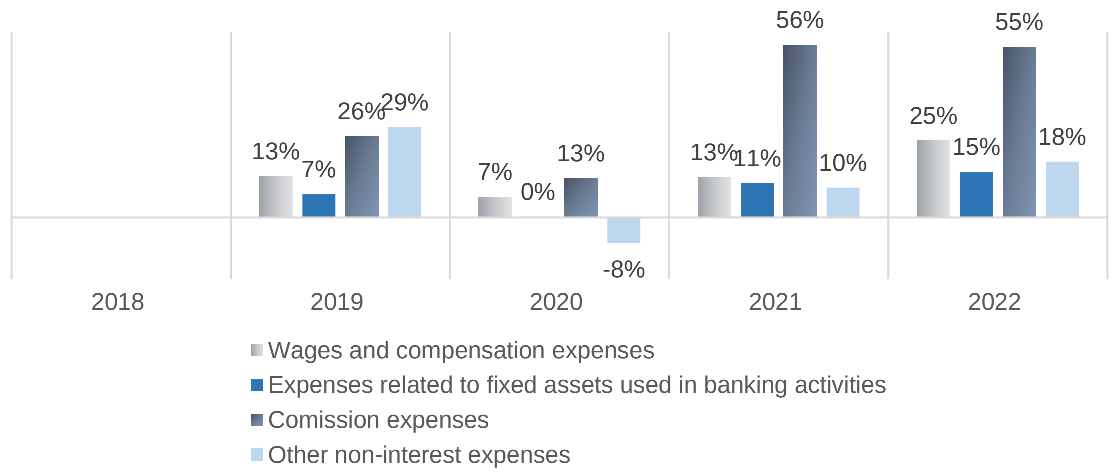
Chart 52. Structure of non-interest expenses



Source: CBA

The drivers of the rise of non-interest expenses in nominal value are salary and commissioning expenses. Salary expenses (39% of non-interest expenses) yoy increased by 25% (AZN146M). At the same time, commissioning expenses (26% of non-interest expenses) increased by 55% (AZN175M), mainly due to the rise in cashless operations and deeper digitalization.

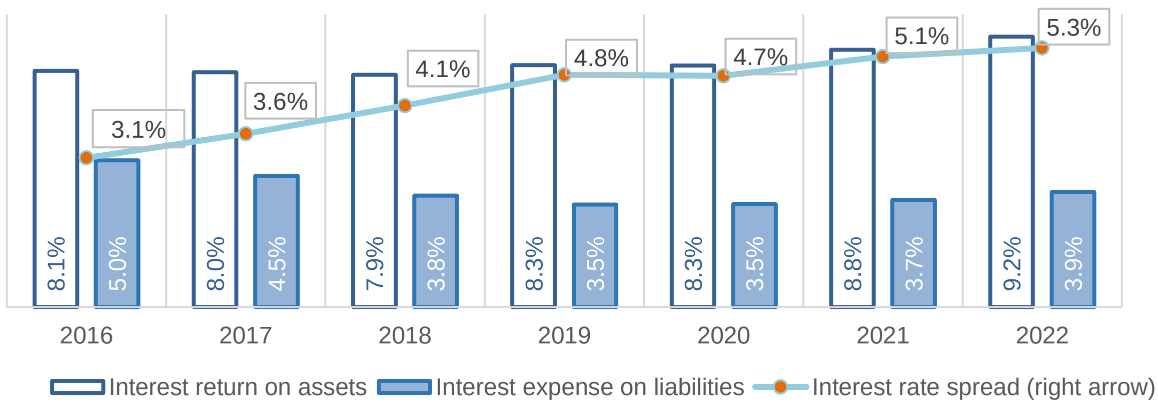
Chart 53. Growth rate of non-interest expenses



Source: CBA

The rising interest rate spread is acting as the main driver of high profitability. The interest rate spread has been rising consistently recent years. High dynamics of consumer lending and the rise in demand deposits with low interest rates contributed to high interest rate spread. Business loans, in particular loans to trade, non-production and agriculture act as another driver of interest income of assets in the sector along with consumer loans. The main component that contributes to non-interest bearing liabilities is term deposits.

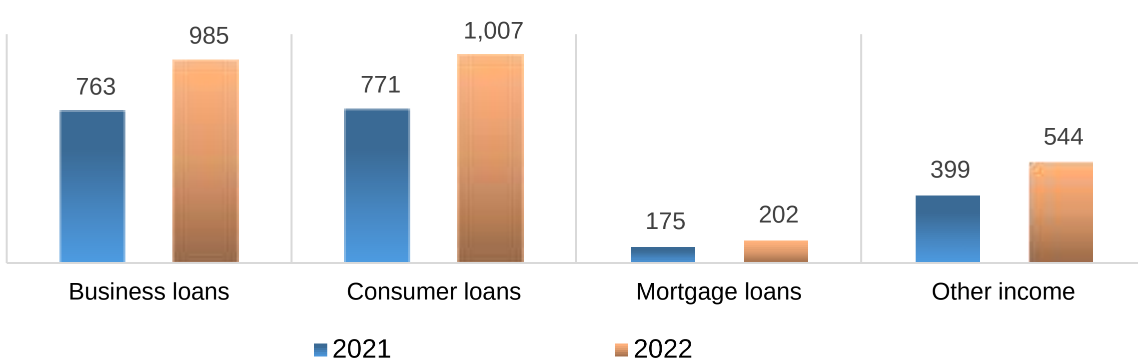
Chart 54. Interest rate spread



Source: CBA

Banks earn interest income from loans. The sector's interest income increased by 30% (AZN632M) and interest expenses increased by 22% (AZN119M) to AZN2.7B and AZN0.65B respectively. Interest income is mainly generated from consumer (AZN1B) and business portfolios (AZN985M) as in the previous year. In 2022 consumer loans accounted for 29% of total lending portfolio, they accounted for 37% of interest income.

Chart 55. Structure of interest income, million AZN

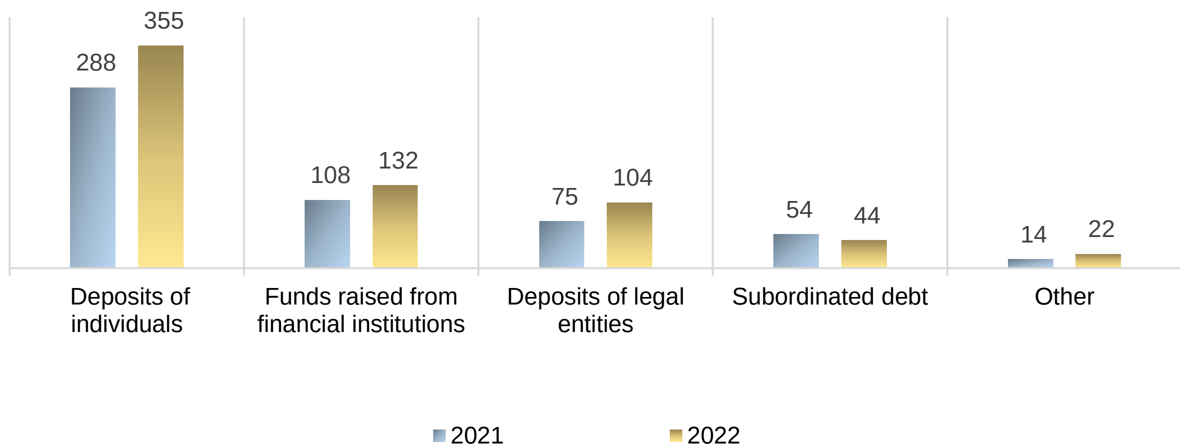


Source: CBA

The business portfolio of the banking system accounted for 55% of the total lending portfolio, they accounted for 36% of interest income.

Expenses related to deposits of individuals constitute the main portion of banks' interest expenses. Deposits of individuals that act as banks' sustainable funding source constitute a considerable portion of interest expenses (53.9% or AZN288M). Other main items of interest expenses include loans of financial institutions and deposits of legal entities.

Chart 56. Structure of interest expenses, million AZN

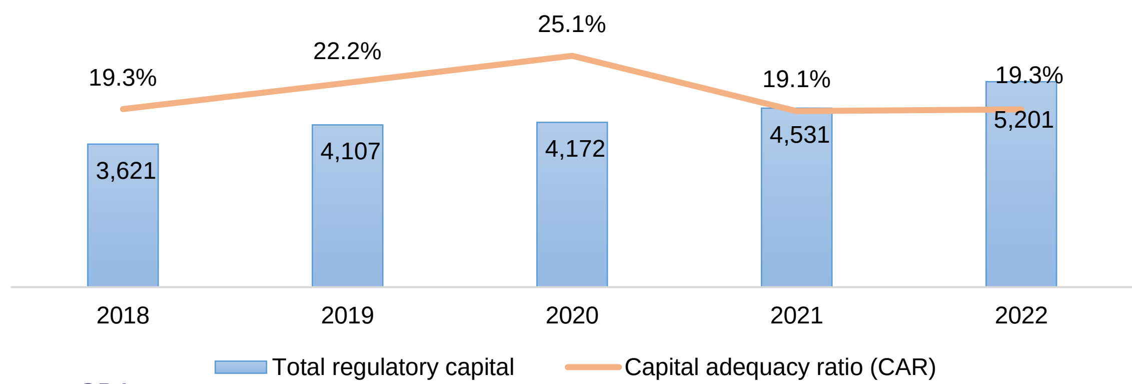


Source: CBA

Capital position of the banking system

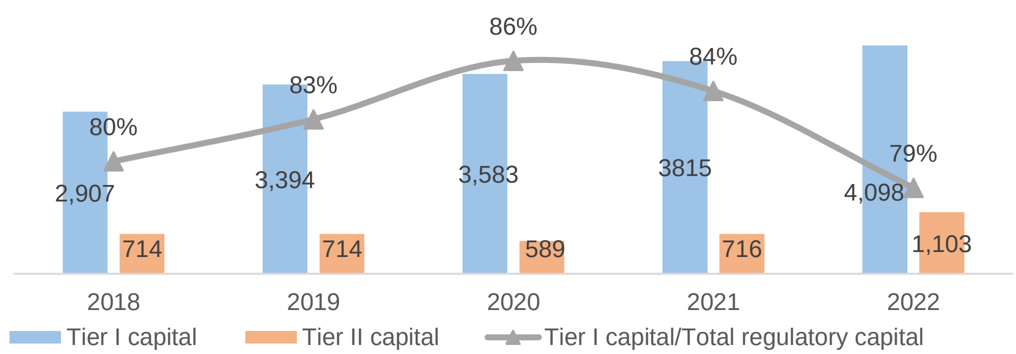
The sector's capital position surpasses prudential requirements and is capable to absorb potential losses. In 2022 aggregate capital of the banking sector increased by 14.8% (AZN670M) to AZN5.2B. The CAR of the sector increased by 0.2 pp to 19.3%, twice as much as the minimum prudential requirement.

Chart 57. Dynamics of capital adequacy, million AZN



Source: CBA

Chart 58. Dynamics of the capital structure, million AZN

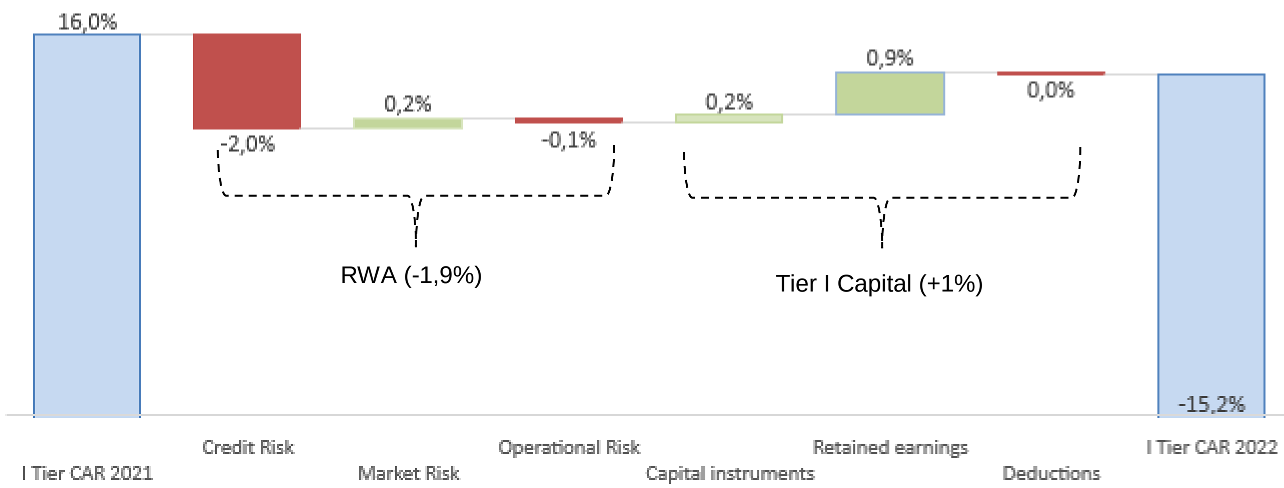


Source: CBA

The rise in aggregate capital was driven by growth in Tier II Capital. Tier I Capital increased by 7.4% (AZN283M) to AZN4.1B, while Tier II Capital increased by 54% (AZN 387M) to AZN1.1B. Capital grew at the expense of banks' internal profit generation. Tier I Capital, considered high quality, mainly increased due to channeling of profit of the previous year to retained net earnings, and Tier II Capital increased at the expense of profit of the current year. Higher profit generation in 2022 reduced the share of Tier I Capital in aggregate capital (79%).

The Tier I CAR yoy decreased by 0.8%, attributable to RWA growth**.** Note that, because of the regulation of the OCP of the International Bank of Azerbaijan, RWA on the market risk in the sector decreased and had an upward effect on capital adequacy.

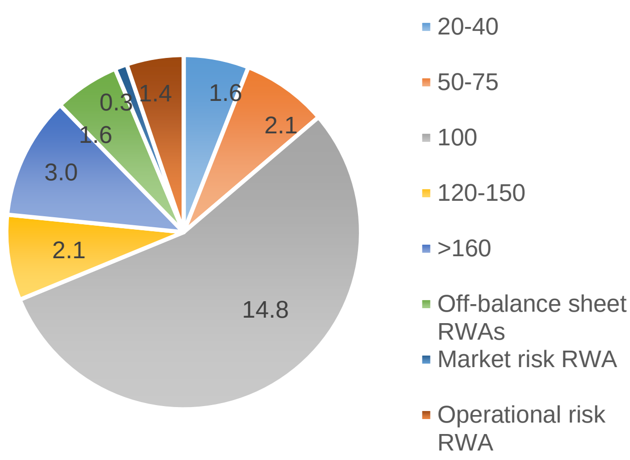
Chart 59. Effect of RWA and Tier I capital movements in Tier I CAR, in percentage



Source: CBA

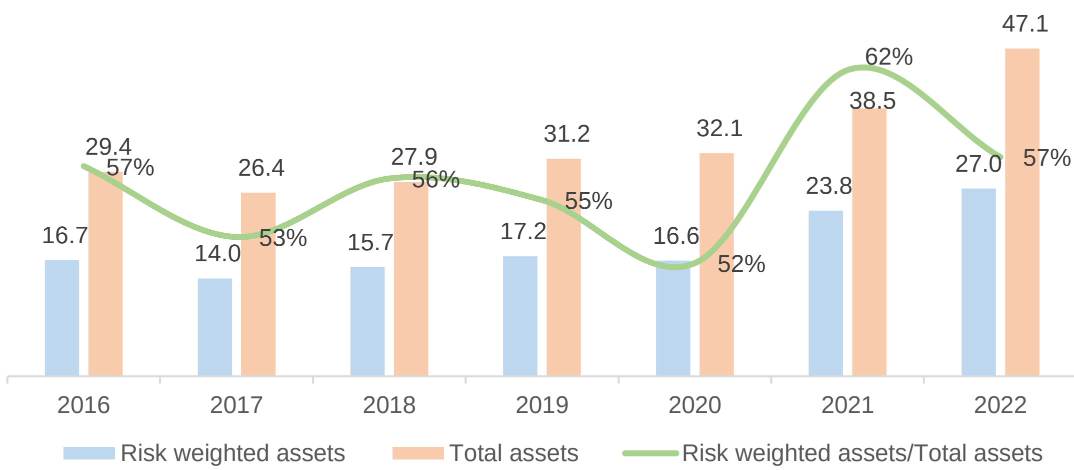
RWA increased in 2022. RWA increased by 13.4% (AZN3.2B) on the backdrop of 22.3% (AZN8.6B) rise in total assets. As a result, the RWA to total assets ratio decreased by 4.5 pp to 57%. Although prudential tightening in 2021 with the increase of RWA requirements on consumer loans, considered riskier, and inclusion of operational and market risks to RWA calculations, raised RWAs, the growth rate of assets was higher over the year. In 2022, RWA amounted to AZN27.0B – AZN25.3B from loans, AZN0.3B from market and AZN1.4B from operational risks.

Chart 60. Breakdown of RWAs on risk categories, billion AZN



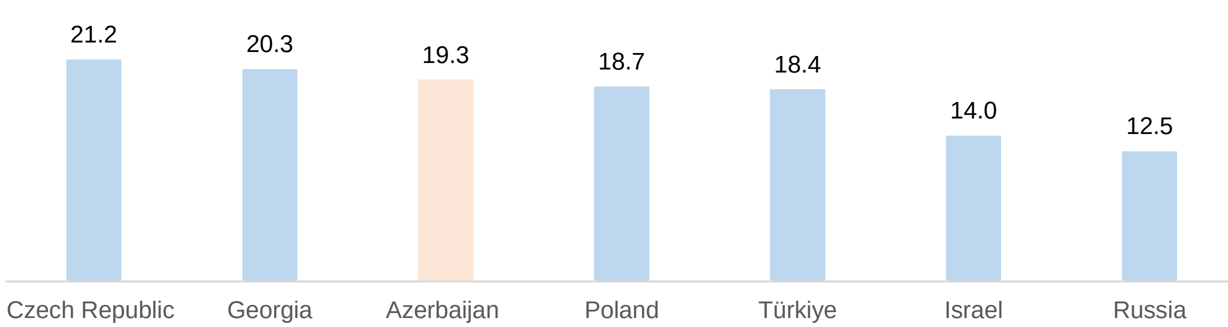
Source: CBA

Chart 61. Dynamics of assets and RWAs, million AZN



Source: CBA

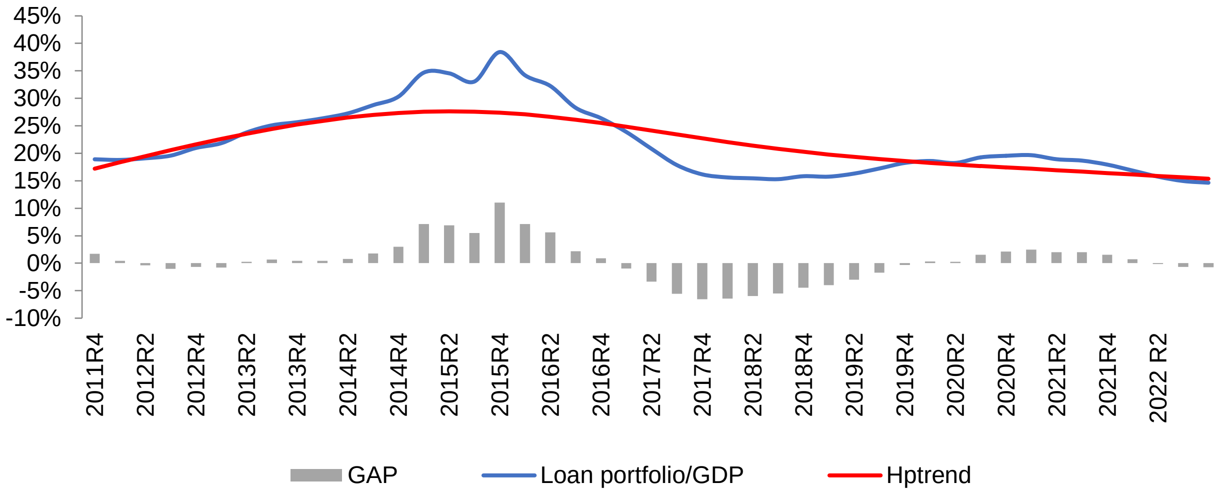
Chart 62. Comparison of the CAR across countries



Source: Recent data from relevant supervisory authorities

The CAR of the Azerbaijani banking system is adequate compared to benchmark countries.

Chart 63. Loan portfolio to GDP ratio, with the HP Trend



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 gap[7] 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 -0.7%.

[7] 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.

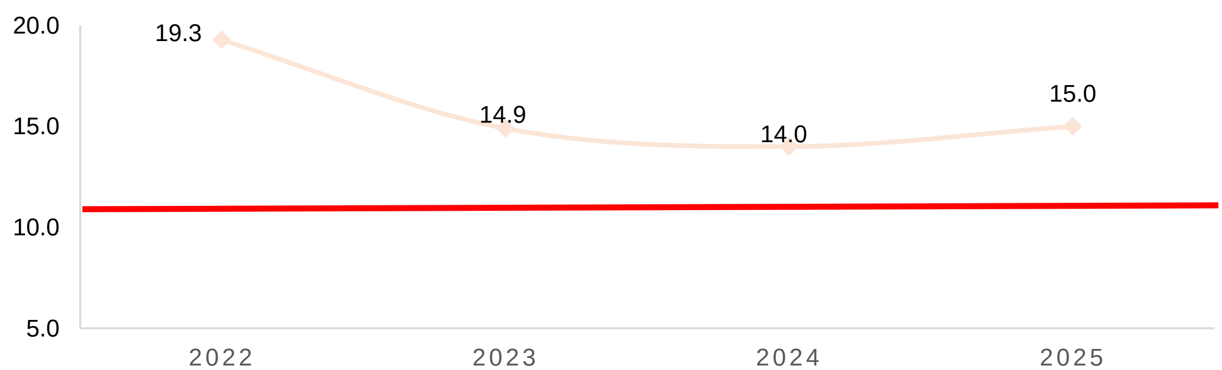
Assessment of banking system resilience

A stress testing assessed the resilience of the banking system to external shocks. A top-down stress testing is maintained to assess banks' capital sustainability under unfavorable macro-financial scenarios and determine relevant mitigation and policy measures. A stress testing methodology allows assessing financial strength of the banking system, in particular resilience of the banking sector to systemic risks and overall capacity of the banking system to underpin economic stability by assessing financial standing of the overall banking system, and individual banks under stress conditions dynamically for next years.

A pessimistic scenario has been developed in light of an extreme but plausible approach to define the effect of macro-economic factors on banks' resilience under stress testing. Scenarios were developed under the adverse scenario guided by the calibration of the 2015-2016 crisis in the country. Macro-economic indicators were forecasted under the pessimistic scenario. Macro-economic indicators were integrated into econometric satellite models and dependent variables were projected for the next years (NPL ratios, interest rates, etc.). At the next stage, based on projected dependent variables, simulations were carried out on credit, interest rate and exchange rate risks and the risk of revaluation of securities, and the financial standing of banks was evaluated on a dynamic basis for upcoming 3 years.

Stress test findings suggest that, the capital buffer of the banking sector is capable to absorb potential losses. Under adverse scenario, the CAR of the banking sector decreases by 4.4 pp to 14.9% in 2023 and 14% in 2024. However, in 2025 on the backdrop of recovery of profitability the CAR increases to 15%.

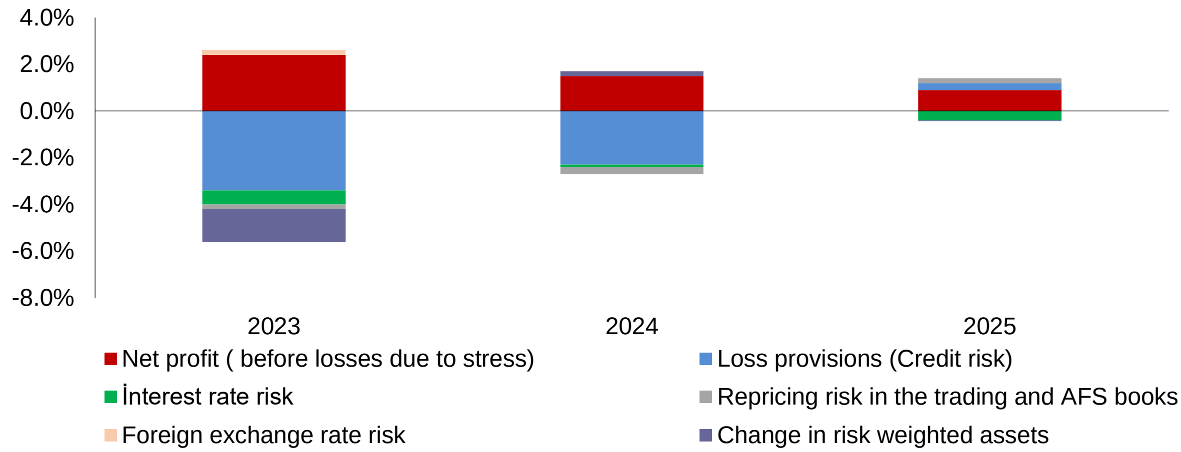
Chart 64. Capital adequacy ratio of the banking system under adverse scenario



Source: CBA

According to stress test findings, the credit risk and changes in RWAs are main channels to affect banks' capital adequacy. In general, although the banking sector underwent capital erosion as a result of stress testing, capital adequacy of the sector exceeds minimum requirements.

Chart 65. Channels of effect on the CAR under adverse scenario



Source: CBA

Box 3. Effect of the new monetary policy framework on banking sector stability

In 2022 the CBA began to use monetary policy tools under a new configuration on 01.09.2022 to strengthen pass-through of the interest rate corridor on inflation. In this context, the Bank began to use standing deposit and credit facilities initiated by banks and expanded the range of open market operations.

Standing facilities allow to maintain one day repo and reverse repo operations. Improvement of open market operations enables the CBA to conduct 7-day repo auctions, if necessary, along with 1,3,6 and 9-month notes for liquidity abrorbing. At the same time, the new framework allows conduction of 7-day reverse repo auctions for liquidity providing purposes.

Chart 66. New configuration of monetary policy tools

The new operational framework is oriented towards strengthening pass-through of monetary policy decisions on inflation through interest rate channels, ensuring balanced growth of credit investments to the economy, optimum distribution of banking system liquidity and supporting equilibrium in the FX market. In general, one can group possible channels of translation of changes made to the monetary policy framework to banking sector stability based on the economic theory as follows:

- **Liquidity distribution.** The new framework both allows banks to effectively manage their liquidity positions and homogenously distribute banking sector liquidity. The new monetary policy expands sterilization options for banks with excess liquidity and allows timely provision of liquidity norms enabling banks to attract short-term funding, if necessary, by supporting unitnterrupted and sustainable settlements.

- **Interest rates.** A new tools arsenal allows to converge interbank interest rates to the interest rate corridor of the Central Bank, resulting in transmission of the interest rate corridor to interest rates in various segments. Hence, higher responsiveness of interest rates allows to strengthen transmission of monetary policy decisions to the financial system.

- **Lending**. Activation of liquidity absorbing operations with the new monetary framework provides additional options for balanced increase in credit investments amid rising inflationary pressures.

- **Competitive environment.** New standing facilities and improved open market operations support a sound competitive environment.

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

	2022 QIV	2022 QIII	2022 QII	2022 QI	2021 QIV	2021 QIII
Balance sheet indicators						
Total assets	47,055	43,633	41,920	39,673	38,462	34,527
Liquid assets	17,242	13,865	15,669	14,925	13,866	11,426
Lending portfolio	19,594	19,157	18,320	17,528	16,659	15,539
Business loans	10,855	10,781	10,482	10,182	9,740	9,002
Consumer loans	5,754	5,602	5,190	4,831	4,518	4,239
Mortgage loans	2,985	2,775	2,649	2,515	2,401	2,297
Total liabilities	41,433	38,288	36,774	34,732	33,493	29,655
Current liabilities	27,048	24,438	24,346	22,831	20,594	18,877
Deposits of individuals	11,483	10,993	10,379	10,201	9,032	8,664
Term deposits of ind-s	6,204	5,964	5,736	5,502	5,339	5,238
Demand deposits of ind-s	5,279	5,029	4,642	4,699	3,693	3,426
Deposits of LEs	22,280	20,381	19,603	18,058	17,906	14,986
Term deposits of LEs	2,578	2,388	2,251	1,934	2,053	2,092
Demand deposits of LEs	19,702	17,992	17,353	16,124	15,853	12,895
Balance capital	5,622	5,345	5,146	4,942	4,969	4,871
Capital position						
Tier I capital	4,098	4,097	4,229	4,265	3,815	3,842
Total regulatory capital	5,201	4,967	4,790	4,528	4,531	4,422
RWAs	26,977	26,980	26,346	25,003	23,781	22,833
Tier I capital adequacy	15.2%	15.2%	16.1%	17.1%	16.0%	16.8%
Total capital adequacy	19.3%	18.4%	18.2%	18.1%	19.1%	19.4%

	2022 QIV	2022 QIII	2022 QII	2022 QI	2021 QIV	2021 QIII
Profitability						
Net profit	914	683	401	174	609	506
ROA	2.2%	2.2%	2.0%	1.8%	1.8%	2.0%
ROE	18.9%	19.2%	17.1%	15.0%	13.6%	15.1%
Liquidity risk profile						
Liquid assets	17,242	13,865	15,669	14,925	13,866	11,426
Share of liquid assets in assets	36.6%	31.8%	37.4%	37.6%	36.1%	33.1%
Instant liquidity ratio	59.9%	55.5%	61.4%	64.0%	61.6%	58.1%
Credit risk profile						
NPLs	735	786	827	812	749	859
Business loans	507	526	552	558	499	556
Consumer loans	185	210	222	192	183	221
Mortgage loans	43	51	53	62	66	81
NPL ratio	3.8%	4.1%	4.5%	4.6%	4.5%	5.5%
Business loans	4.7%	4.9%	5.3%	5.5%	5.1%	6.2%
Consumer loans	3.2%	3.8%	4.3%	4.0%	4.1%	5.2%
Mortgage loans	1.4%	1.8%	2.0%	2.5%	2.8%	3.5%
Market risk profile						
Asset dollarization	40.5%	40.8%	40.0%	39.9%	39.4%	38.9%
Liability dollarization	45.0%	45.0%	45.7%	46.5%	45.3%	46.1%

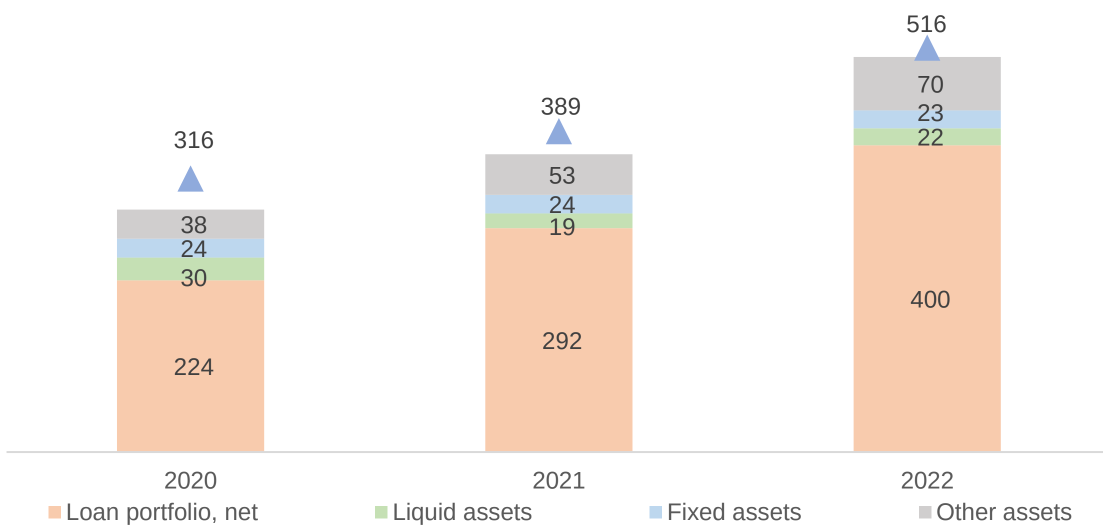
** calculated based on the prudential reporting methodology*

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 1.0% in terms of assets[8]. In 2022, licenses of 4 NBCIs were revoked, thus, the number of operating NBCIs dropped to 95. 14 NBCIs are operating with foreign capital, in 11 out of them the share of foreign capital is over 50%. As of end-2022, NBCIs numbered 55 and credit unions (CUs) numbered 40. Over the year the number of employees of NBCIs increased by 296 persons to 2859 persons, the number of branches increased by 21 units to 287. No new license was issued over the reporting period.

The balance of NBCIs expanded in 2022. Total assets of NBCIs increased by 33% (AZN127M) to AZN516M, driven by net lending portfolio. The net lending portfolio increased by 37% (AZN108M) because of consumer loans (AZN62M).

Chart 67. Dynamics of assets of NBCIs, million AZN



Source: CBA

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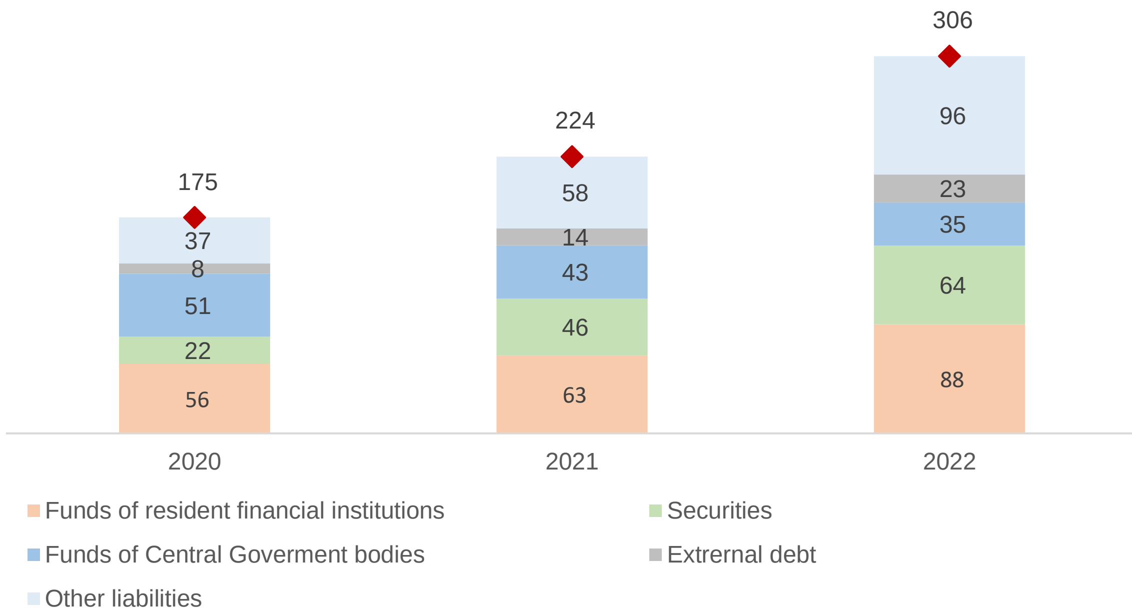
[8] *The 'Agrarcredit' CJSC was skipped in the analysis of NBCIs.*

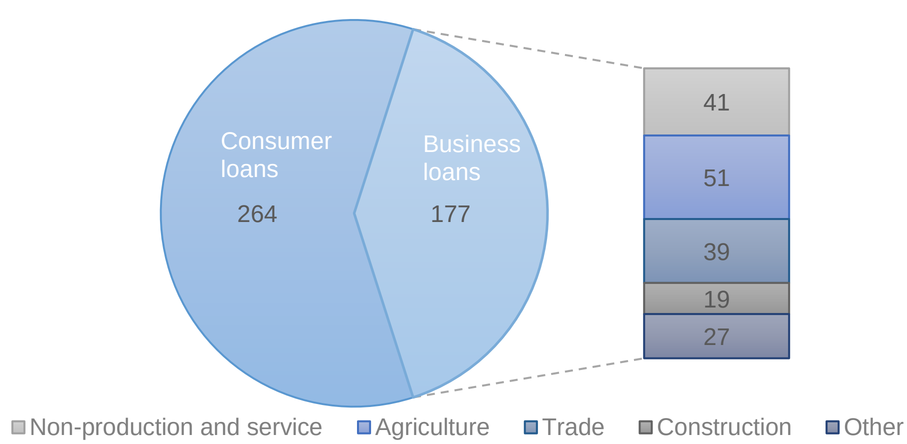
Chart 68. Dynamics of liabilities of NBCIs, million AZN



Source: CBA

Asset growth was driven by the growth of liabilities of NBCIs due to the financial system. Total liabilities of NBCIs increased by 37% (AZN82M) to AZN306M, owing to loans of banks and other financial institutions (AZN35M) and securities (AZN18M).

Chart 69. Structure of the lending portfolio of NBCIs, million AZN



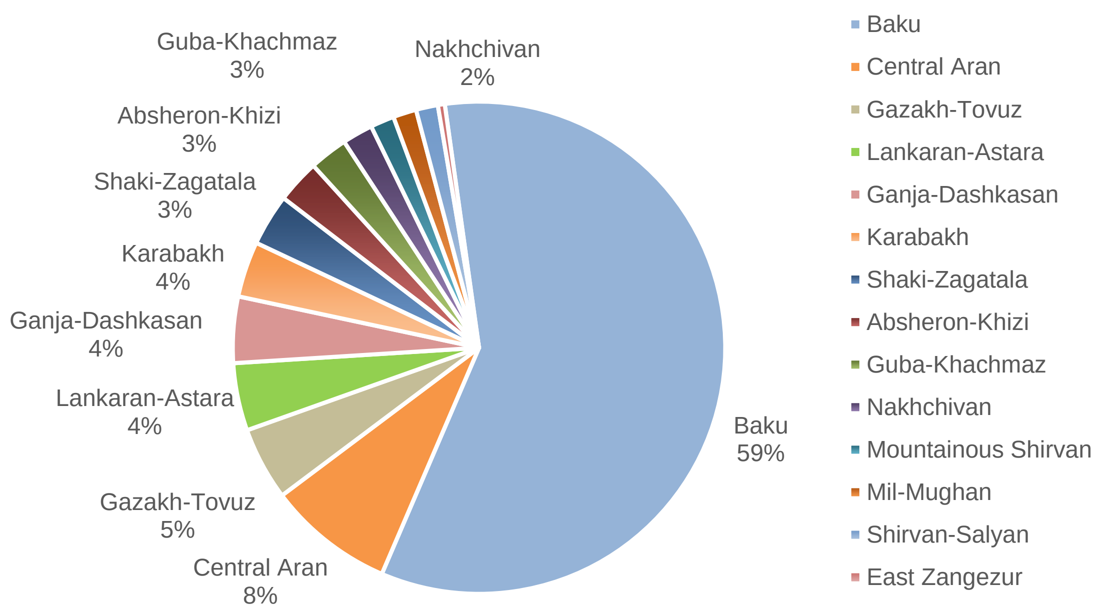
Source: CBA

In 2022, consumer loans still took the main share in the portfolio of NBCIs. The lending portfolio increased by 32% (AZN107M) to AZN440M. Consumer loans yoy increased by 31% and business loans by 34%. As of end-2022 consumer loans account for 60% (AZN264M) and business loans for 40% (AZN176M) of the lending portfolio of NBCIs. The business portfolio includes loans to agriculture (22% or AZN51M), to non-production and services (18%, or AZN41M) and to trade (17%, or AZN39M).

The quality of the lending portfolio increased amid lending portfolio growth. In 2022 the NPL portfolio of the sector decreased by 5.3% to AZN66.5M. The NPL ratio decreased by 6 pp to 15%. The NPL portfolio decreased both on consumer and business loans.

The NBCI sector is concentrated. There are only 15 NBCIs in the sector whose assets are higher than AZN10M (74% (AZN383M) of total assets of NBCIs. Moreover, there is considerable concentration across regions. 59% of loans issued across the sector is concentrated in Baku.

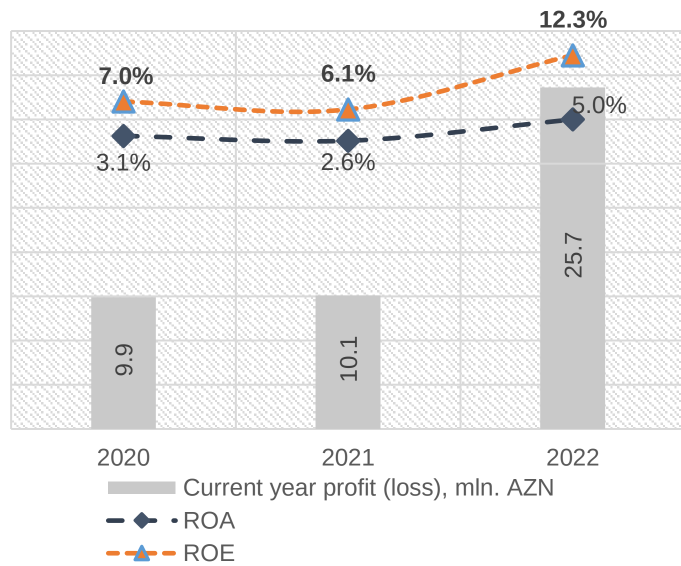
Chart 70. Distribution of loan portfolio by economic regions



Source: CBA

The sector keeps generating profit. In 2022 profitability of NBCIs was the highest of recent 5 years, yoy up by 2.5 times. Profitability of the sector was driven by higher operating efficiency of credit institutions in addition to interest income increased with the lending portfolio growth. ROA and ROE of the sector yoy doubled to 5% and 12.3% respectively. The **capital position of the sector is following a positive trend.** Over the year capital of NBCIs increased by 28% (AZN46M) to AZN210M. Capital growth was derived from both capital injection and profit generation of NBCIs.

Chart 71. Profitability indicators of NBCIs



Source: CBA

Chart 72. Dynamics of capital components across NBCIs, million AZN

Source: CBA

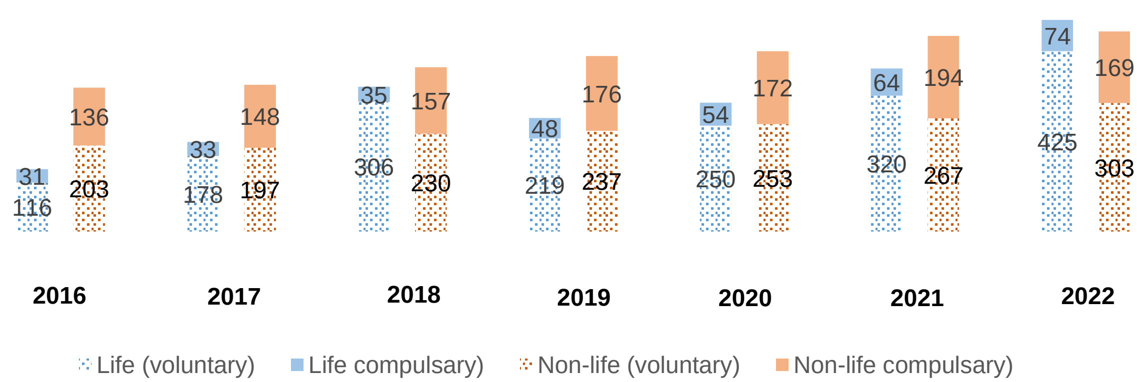
Insurance sector

As of end-2022, there were 20 insurance companies and one reinsurance company in the Azerbaijani insurance market, out of which 5 are life and 15 non-life insurance companies. 29 insurance brokers and 652 insurance agents contributed to the insurance sector.

Insurance premiums increased. Insurance premiums yoy increased by 15% (AZN127M) to AZN971M. Voluntary insurance increased by 24% (AZN141M) and compulsory insurance decreased by 6% (AZN14.6M). Growth of voluntary insurance was driven by endowment life insurance. Insurance premiums collected on endowment life insurance increased by 45% (AZN124M) to AZN397M. In general, compounded annual growth rate of insurance premiums[9] was 12.2%. The relevant indicator stood at 15.7% on life insurance classes and at 5.6% on non-life insurance classes over recent 6 years.

Over the year insurance claim expenses decreased. Payments yoy decreased by 6% (AZN26M) to AZN433M. Whereas payments on voluntary life insurance classes

Chart 73. Dynamics of insurance premiums, million AZN

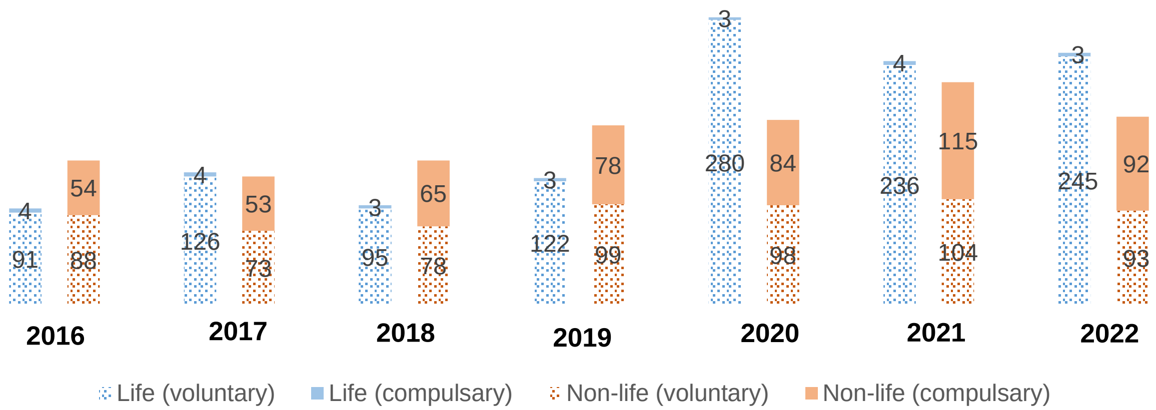


Source: CBA

increased, they decreased on non-life insurance classes. Payments on non-life insurance classes decreased by 15% (AZN34M) to AZN185M, driven by non-life compulsory insurance. Payments on voluntary life insurance classes increased by 4% (AZN9M) to AZN245M.

[9] *CAGR – (compounded annual growth rate) average annual growth rate of the portfolio with over one year maturity.*

Chart 74. Dynamics of insurance claim expenses, million AZN

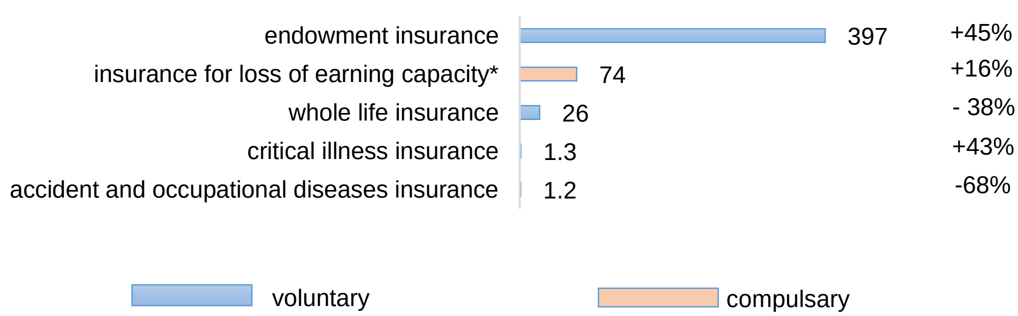


Source: CBA

- ***Breakdown of insurance premiums across classes:***

The endowment life insurance takes the main part of insurance premiums on life insurance classes (AZN397M, 79% of total life insurance premiums). Over the year main growth was in this insurance class (up by 45% or AZN124M).

Chart 75. Structure of life insurance premiums on classes, million AZN



Source: CBA

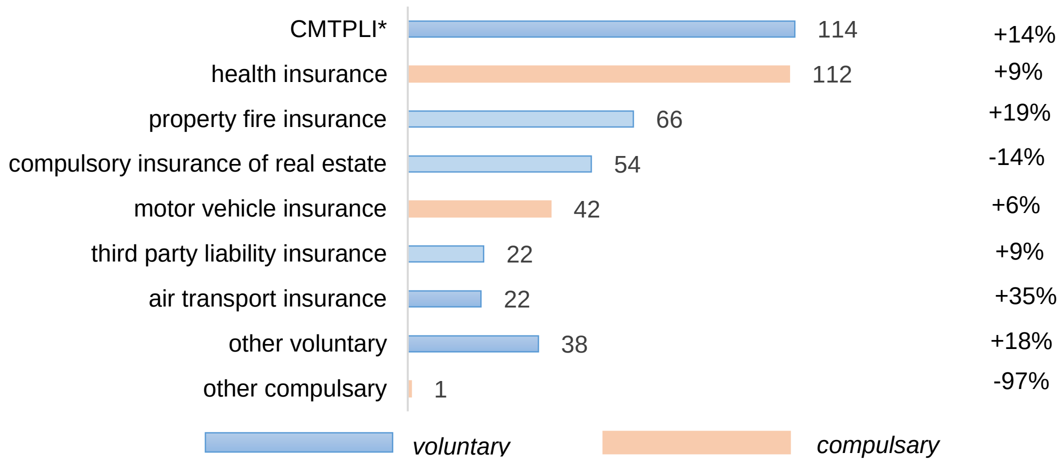
CMTPLI** (AZN114M, 24% of total non-life insurance premiums), voluntary medical insurance (AZN112M, 23.8% of total non-life insurance premiums) and property fire insurance (AZN66M, 14% of total non-life insurance premiums) have the main share among non-life insurance classes. Over the year growth on non-life insurance was in CMTPLI (AZN14M, +14%), property fire insurance (AZN11M, +19%) and medical insurance classes (AZN10M, 9%), and main reduction was in compulsory real estate insurance (AZN9M, -14%) and other compulsory insurance classes (AZN31M, -97%).

* *Compulsory insurance against industrial accidents and occupational diseases*

** *CMTPLI – compulsory motor third party liability insurance*

The drop in insurance premiums in other compulsory insurance classes is attributable to the fact that authorities on state compulsory personal insurance were assigned to the Ministry of Labor and Social Protection of the Population from 1 January 2022 onward.

Chart 76. Structure of non-life insurance premiuns across classes, million AZN

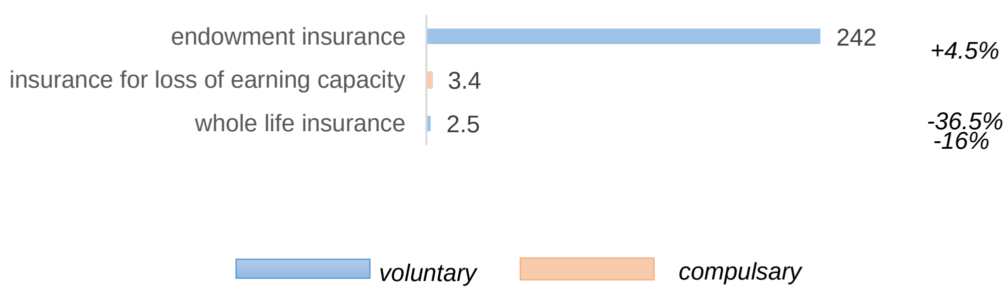


Source: CBA

- ***Breakdown of insurance payments across classes***

The endowment life insurance acts as the main class in the structure of life insurance classes. Endowment life insurance payments yoy increased by 4.5%, 99% (AZN242M) of total life insurance payments (AZN245M).

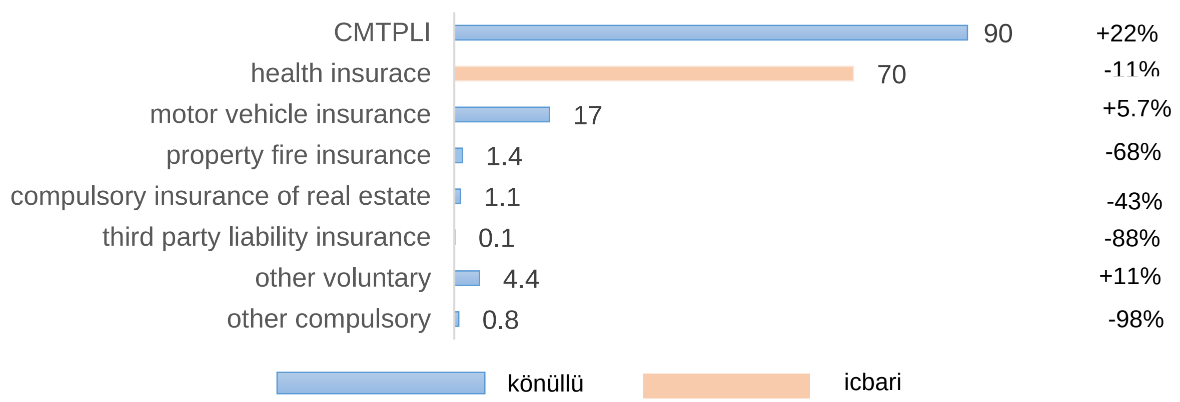
Chart 77. Structure of life insurance payments on classes, million AZN



Source: CBA

Medical insurance (AZN70M, 38% of non-life insurance payments) and CCLIMVO (AZN90M, 49% of non-life insurance payments) account for the main part of non-life insurance payments. The highest growth in payments was in CMTPLI (AZN16M, 22%). The drop in payments was driven by other compulsory insurance classes. Due to transfer of authorities on state compulsory personal insurance to the MLSPP payments on this class dropped by AZN39M (-98%). Drop on types of voluntary insurance was on medical insurance (AZN8.7M, -11%).

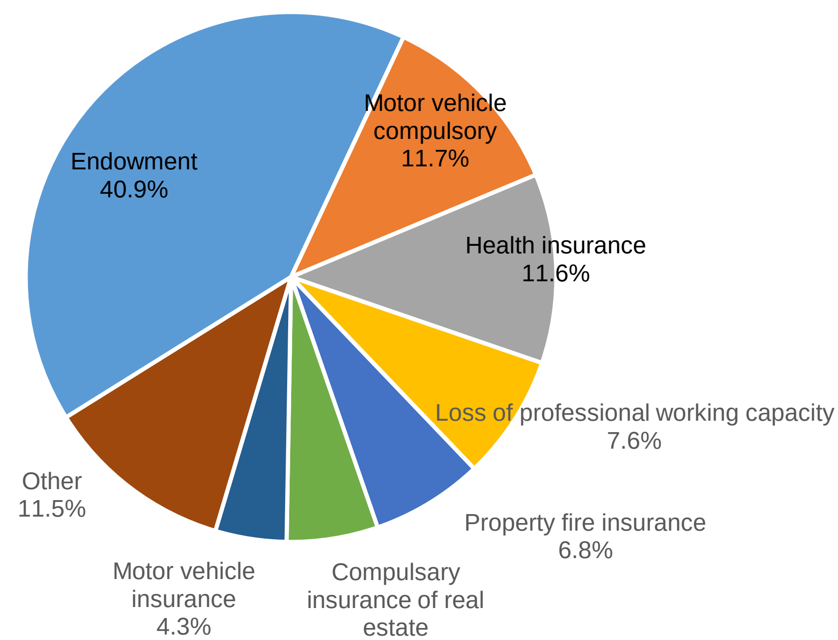
Chart 78. Structure of non-life insurance payments across classes, million AZN



Source: CBA

There is concentration on classes in the insurance sector. Over half of insurance premiums is concentrated on three insurance classes. In 2022, main insurance classes accounted for 64% of total premiums.

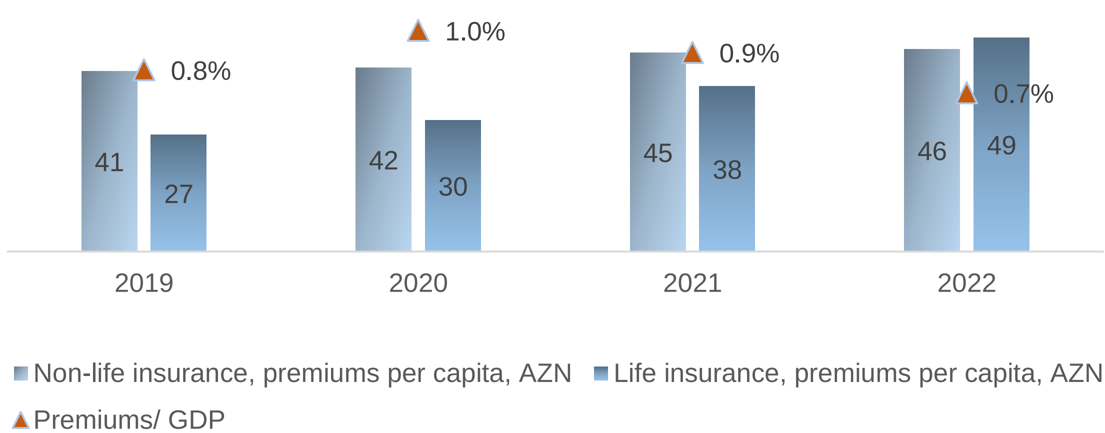
Chart 79. Structure of insurance classes on premiums



Source: CBA

Whereas the share of insurance premiums in GDP decreased, per capita insurance premium increased at the expense of life insurance. The share of insurance premiums in GDP yoy dropped by 0.2 pp to 0.7%. Reduction of the ratio relates to the fact that GDP growth was higher than that of insurance premiums. Nevertheless, per capita total insurance premium increased by 14% to AZN95, driven by life insurance. Per capita insurance premium on life insurance increased by 29.6% to AZN49. Insurance sector penetration is of the main strategic activity directions of the CBA and the Bank makes initiatives to that end.

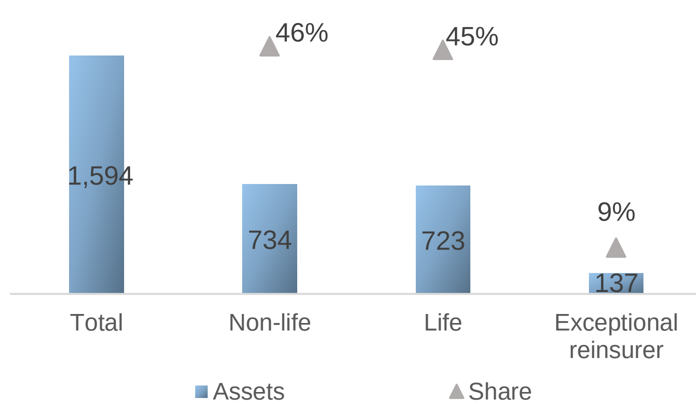
Chart 80. Insurance sector penetration level



Source: CBA

Sector's assets yoy increased by 20% (AZN269M) to AZN1594M. Assets of the non-life sector increased by 7% (AZN51M) to AZN734M, while assets of the life sector increased by 33% (AZN179M) to AZN723M. Assets of the an exceptional reinsurer increased by 38% to AZN137M.

Chart 81. Insurance sector assets, million AZN

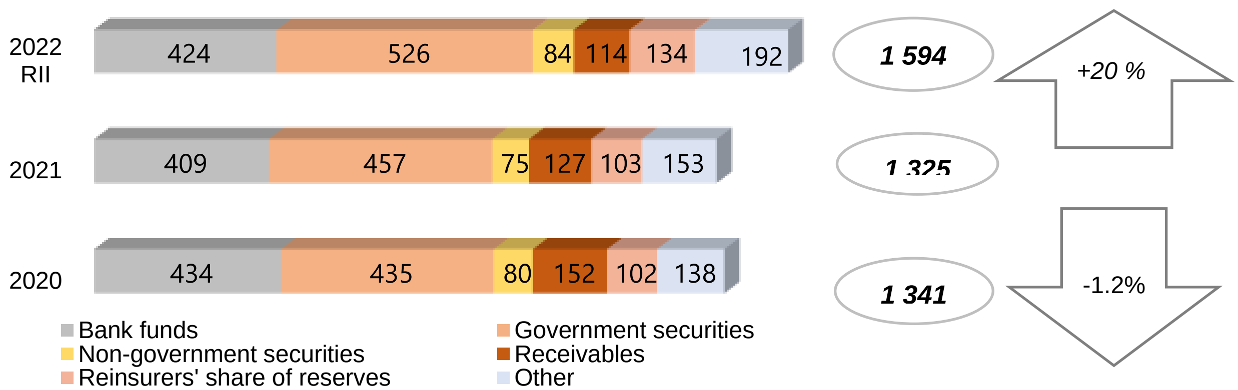


Source: CBA

Insurance sector assets are mainly invested in GSs and funds with banks. The investment portfolio accounts for 78% of insurance sector assets. 40% (AZN632M) of assets are invested in

GSs, 27% (AZN437M) in funds with banks, 5% (AZN87M) in NGSs, 5% (AZN77M) in stocks and 1% (AZN16M) in real estate and other financial assets. The GSs portfolio of the insurance sector includes life insurance companies (63%), non-life insurance companies (27%) and the AzRe (10%). Total 94% of the investment portfolio of insurance companies is concentrated in Azerbaijan.

Chart 82. Dynamics of asset components, million AZN



Source: CBA

Funds of insurers with domestic banks increased. Funds of the insurance sector with domestic banks yoy increased by 6% (AZN22M) to AZN392M.

Liabilities of the insurance sector increased amid the rise in insurance reserves.

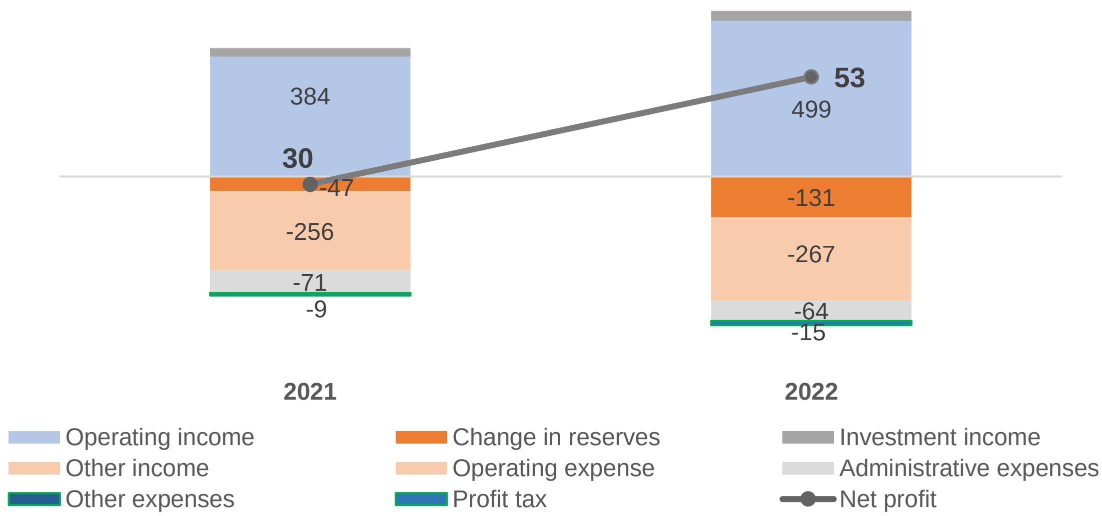
In 2022 total liabilities of the insurance sector increased by 31% (AZN261.3M) to AZN1095M, and insurance reserves increased by 26% (AZN194.3M) to AZN936.7M. 95% of long-term liabilities (90% of total liabilities) is reserves of the insurance sector, and 71.3% of short-term liabilities (10% of total liabilities) covers short-term accounts payables.

Chart 83. Funds of insurance companies with domestic banks, million AZN

Source: CBA

Profitability of the sector is mainly derived from life insurance sectors. Profitability of the life sector increased over the year. Net profit of the sector increased by 76% (AZN23M) to AZN53M. Profitability resulted from the 30% (AZN115M) rise in operating income and the 10% (AZN7.1M) drop in operating cost. 1.8 times (AZN84.4M) growth of net insurance reserves had a downward effect on profitability.

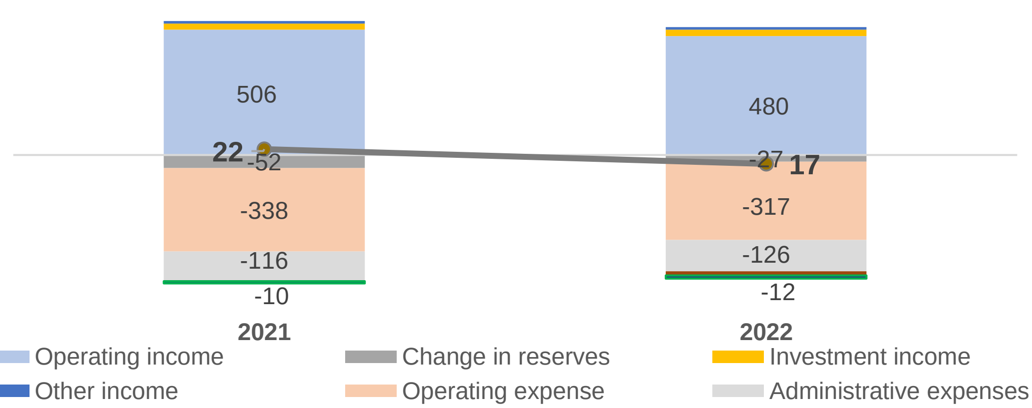
Chart 84. Profitability indicators of life insurance companies, million AZN



Source: CBA

Profitability of the non-life insurance sector decreased by 23% (AZN5.0M) to AZN17M, due to yoy drop in operating income by 5% (AZN25M). At the same time, the rise in operating costs and other expenses by 9% (AZN11M) and 3.2 times (AZN13M) contributed to the drop in net profit.

Chart 85. Profitability indicators of non-life insurance companies, million AZN



Source: CBA

Profitability on life and non-life insurance classes varies. Recent five years net profit on life insurance classes doubled to AZN53M, ROA remained the same due to relevant growth in assets, while ROE increased by 14 pp. The capital to assets ratio decreased by 10 pp as a result of the rise in premiums and assets. Net profit on non-life insurance decreased by two times to AZN17M. ROA decreased by 4 pp and ROW by 4 pp. The leverage indicator increased as well. The capital to assets ratio decreased by 21 pp.

Chart 86. Dynamics of profitability on life insurance

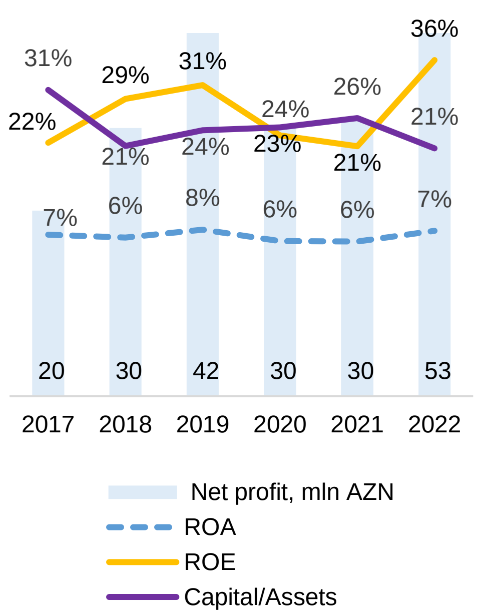
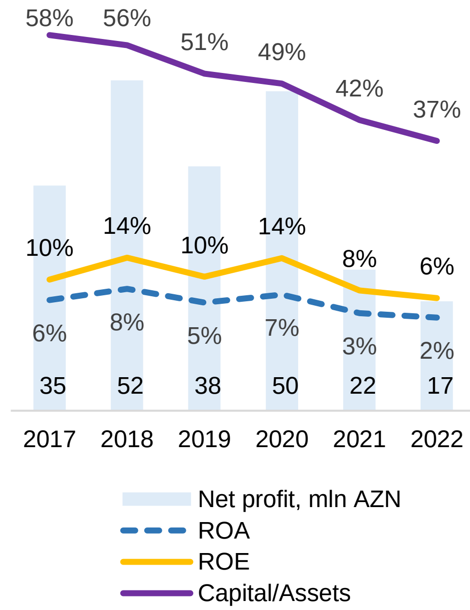


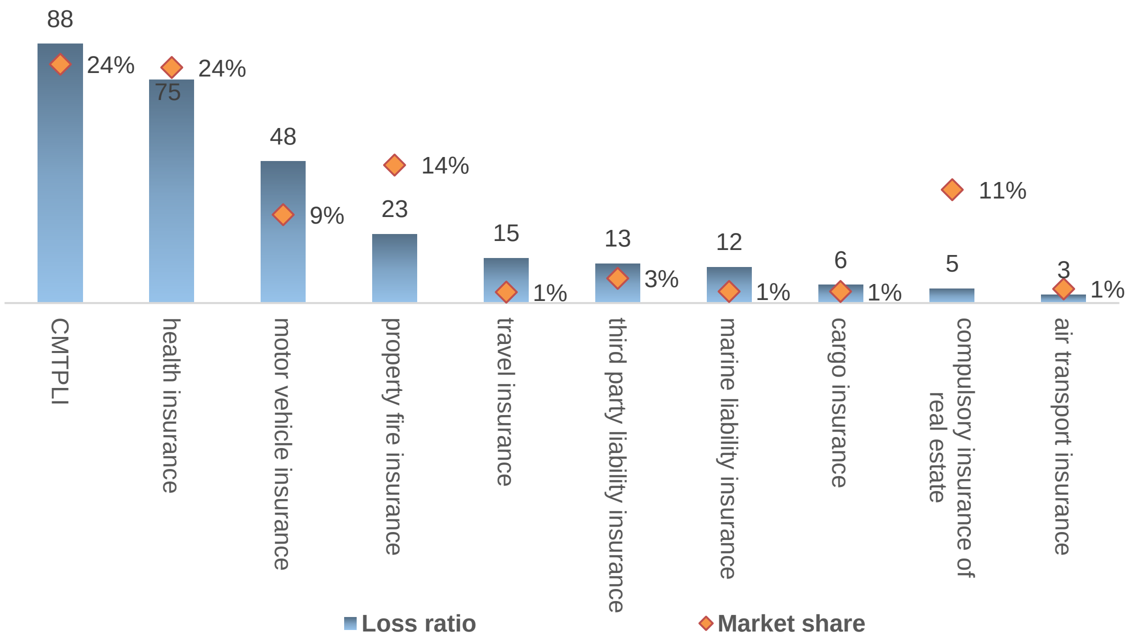
Chart 87. Dynamics of profitability on non-life insurance



Source: CBA

Classes with the highest loss ratio in non-life insurance are those with a high market share. Classes with the highest loss include CCLIMVO, medical and voluntary car insurances. In general, the market share of classes with the highest loss ratio is 57%.

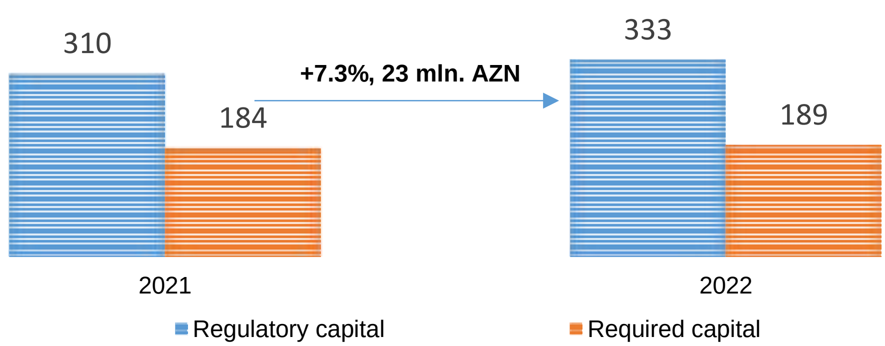
Chart 88. The loss ratio across insurance sector classes



Source: CBA

Insurance sector's capital requirement exceeds required capital norms. In general, in 2022, balance capital of the insurance sector (including AzRe) amounted to AZN499M and aggregate capital amounted to AZN333M. Aggregate capital on life insurance is two times higher than required capital (AZN60M) and makes AZN 118M. The same indicator for the non-life insurance sector is 47% (AZN52M) higher and makes AZN162M.

Chart 89. Dynamics of regulatory and required capital, million AZN

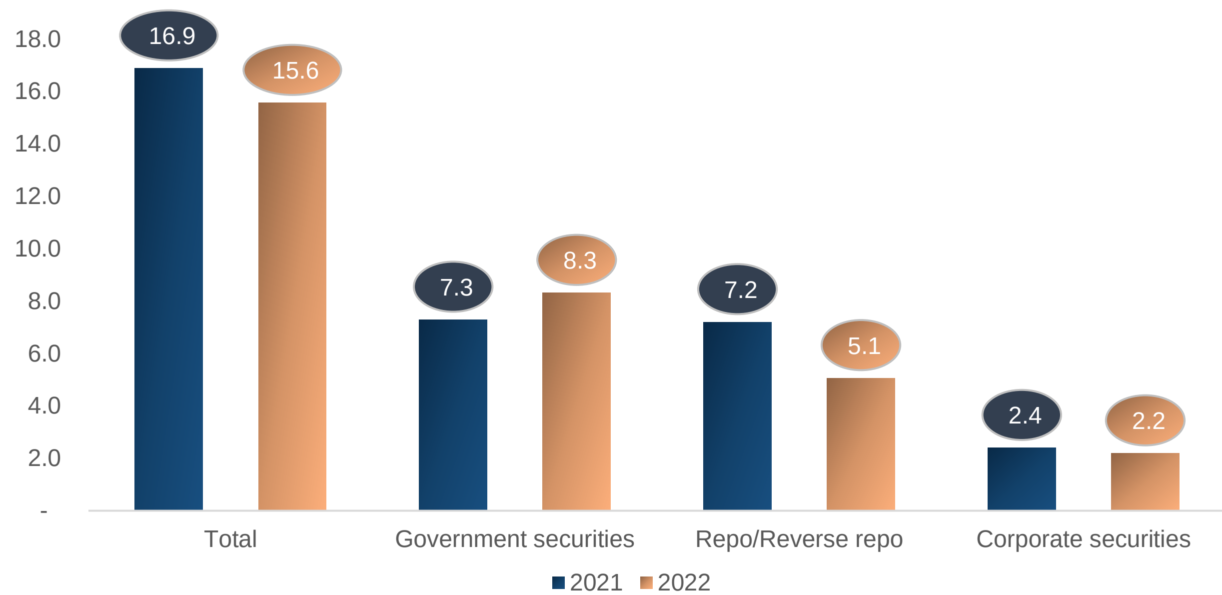


Source: CBA

Capital market

Although the securities market contracted year over year in 2022, turnover of GSs increased. Trade turnover of the GS market yoy decreased by 7.8% to AZN15.6B, driven by repo/reverse repo operations. In 2022 repo/reverse repo operations decreased by 29.7% (AZN2.1B) to AZN5.1B. Moreover, turnover of the corporate securities market decreased by 8.6% (AZN0.2B) to AZN2.2 B. On the other hand, turnover of GSs increased by 14.1% (AZN1.03B) to AZN8.3B.

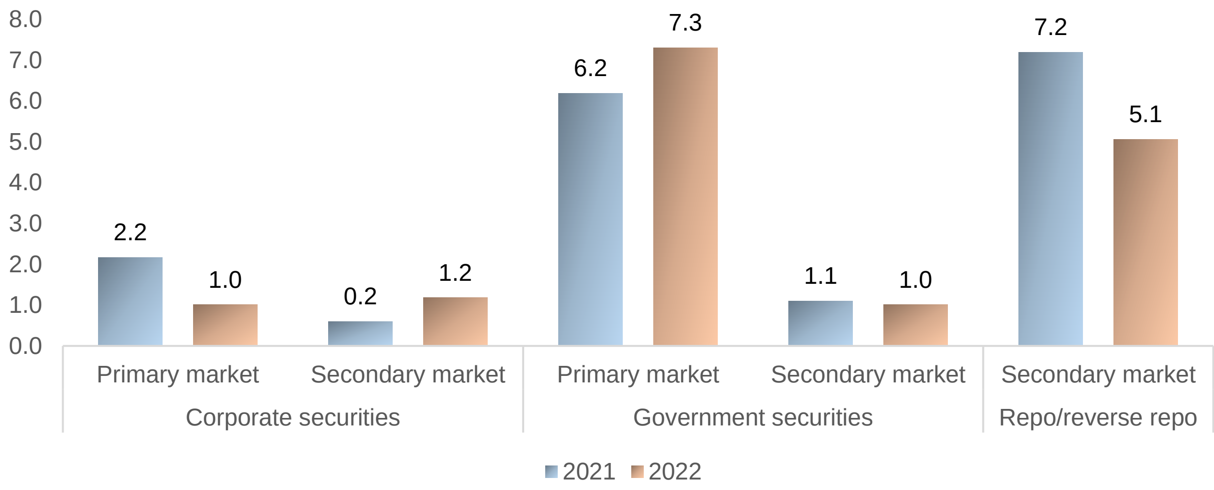
Chart 90. Capital market turnover, billion AZN



Source: CBA

Activity in the primary GSs market and the secondary corporate securities market was high. Whereas the secondary market turnover of GSs decreased by 8.2% (AZN0.1B), their primary market turnover increased by 18% (AZN1.1B) to AZN7.3B. The main reason for lower market turnover of corporate securities was the yoy drop in primary market operations by 53% (AZN1.2B). Albeit the said drop, 4.1 times (AZN1B) rise in turnover of corporate securities in the secondary market prevented dramatic surge in the turnover of the corporate securities market.

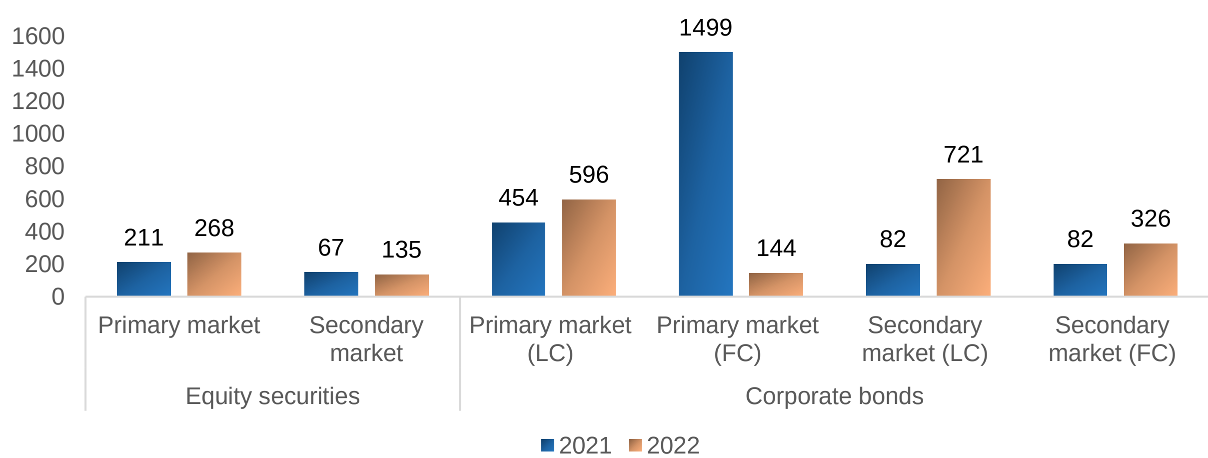
Chart 91. Primary and secondary market operations, billion AZN



Source: CBA

Turnover of the corporate securities market amounted to AZN2.2B; there was dramatic surge in transactions with corporate securities in the stock exchange. Over the reporting period the stock market increased by 45% and the corporate bonds market decreased by 16%. Foreign currency operations decreased and national currency operations increased in the corporate bonds market. The value of operations with corporate securities in the regulated market increased over the period. Public offering of corporate securities at the Baku Stock Exchange elevated, total trade turnover of corporate securities increased by 93% to AZN1.6B. Higher value of operations with corporate securities in the regulated market conditions more transparency, effectiveness and liquidity in the market, which in its turn eases access of issuers to capital.

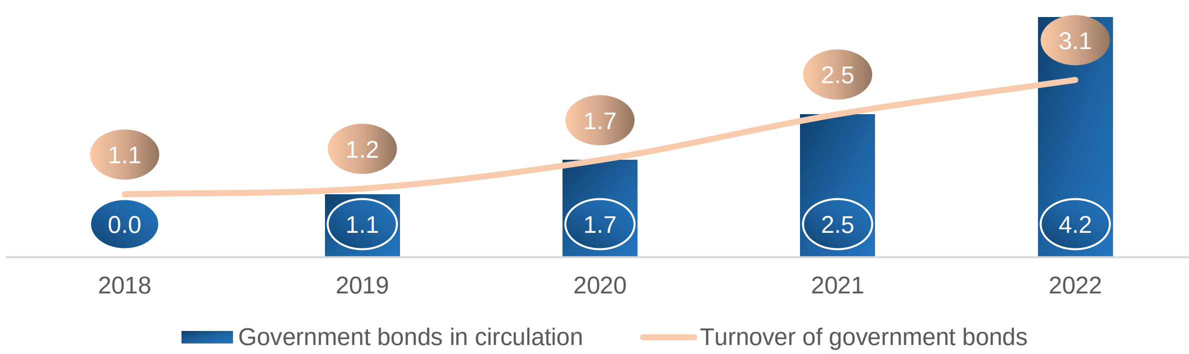
Chart 92. Value of transactions in the corporate securities market, million AZN



Source: CBA

Circulation of government bonds keeps increasing. In 2022 turnover of government bonds yoy increased by 24% (AZN0.6B) to AZN3.1B. On the backdrop of the rise in turnover of government bonds the value of government bonds in circulation increased at the expense of the issue of GSs. The fact that government bonds are long-term and low-coupon stipulates that they have long duration.

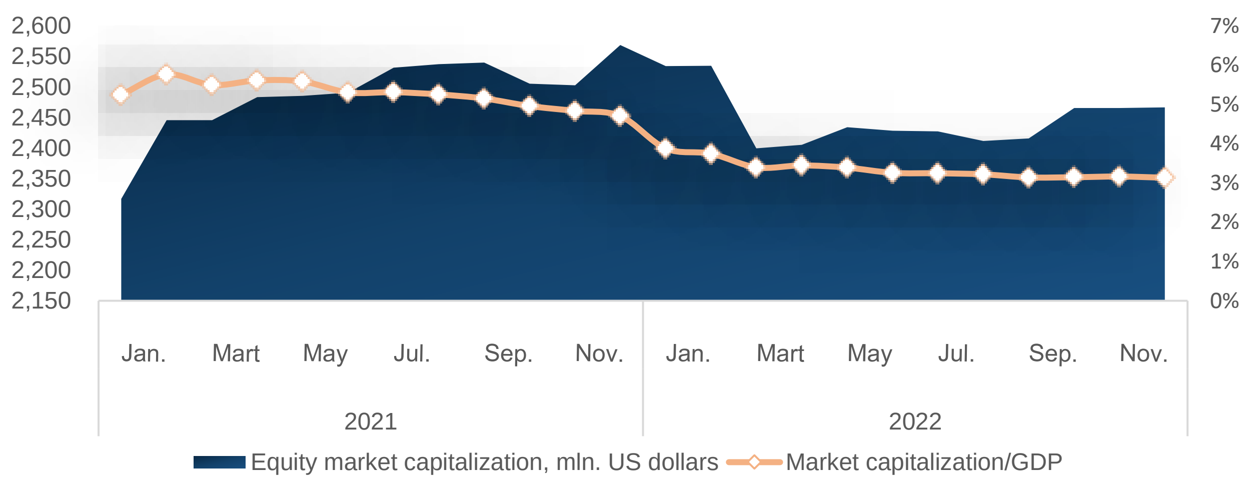
Chart 93. Dynamics of government bonds, billion AZN



Source: CBA

Potential for the penetration and deepening of capital markets remains high. In 2022 capitalization of the stock market decreased by 4% ($102M) to $2.47B. The depth of the stock market decreased by 1.57 pp to 3.13% on the backdrop of low market capitalization and considerable GDP growth.

Chart 94. Equity market capitalization (US dollars) and penetration

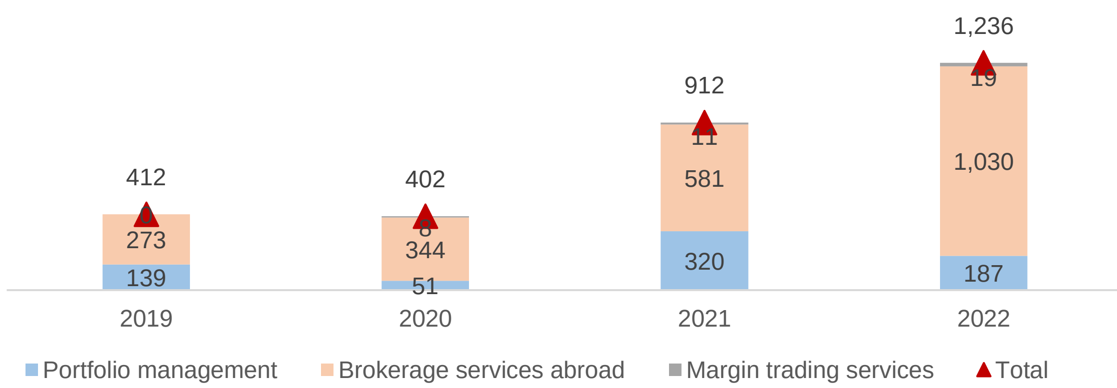


Source: CBA

Continuous measures are under way to improve the securities market and increase infrastructure capacity and depth. According to amendments made to the Tax Code, dividends, discounts and interest income on stocks and bonds publicly offered in the regulated market, as well as allowed to trading are tax exempted for five years from 1 February onward. In addition, the Central Bank developed and delivered to the Cabinet of Ministers draft amendments to the Civil Code of the Republic of Azerbaijan to a create a legislative base on green bonds. The MCGF of the Republic of Azerbaijan decided to issue guarantee on manat denominated corporate bonds issued by issuers in accordance with the relevant Decree of the President of the Republic of Azerbaijan to elevate options for financing through the capital market. The mechanism is to be introduced in 2023.

Challenges related to the institutional development of the capital market also require the modernization of the market infrastructure. The CBA established the Securities Issuance System for the purpose. The system provides issuers with easier market access and more flexible financing options through digital channels. The creation of the Securities Issuance System elevated liquidity and trade turnover in the corporate securities market, very critical for the formation of more transparent and effective environment. Moreover, efforts are under way to launch a centralized operating system covering trade and post-trade transactions in the capital market. The new operating system will be commissioned in Q1 2023. Works completed on opening mutual nominal holder accounts between the capital markets of Turkey and Azerbaijan. It will both simplify procedures for maintaining capital market operations by investors in Azerbaijan and Turkey and boost mutual investment opportunities to the capital market.

Chart 95. Dynamics of customer assets of investment companies, million AZN

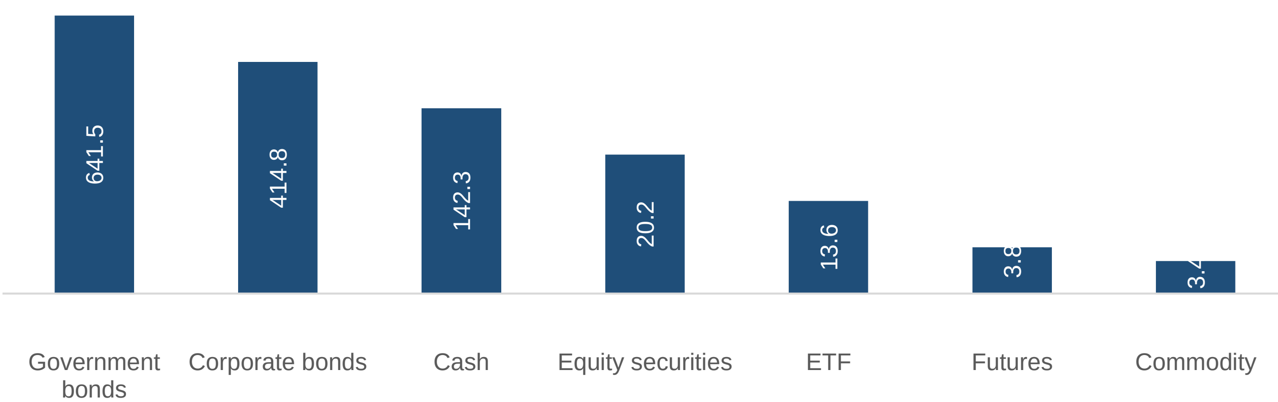


Source: CBA

Customer assets of investment companies expanded. Customer assets of investment companies yoy increased by 36% (AZN324M) to AZN1236M, driven by brokerage services in the foreign market. In 2022 customer assets on brokerage services in the foreign market increased by 77% (AZN449M). On the other hand, customer assets on portfolio management decreased by 42% (AZN133M). While growth in customer assets across the sector is positive, their concentration is high.

Customer assets are mainly invested in low-risk securities. In 2022 investors invested their funds in GSs considered low-risk securities (52%, AZN641.5M), corporate bonds (33%, AZN414.8M) and money funds (11%, AZN142.3M). Demand for derivative financial instruments was low amid small size of risky investments.

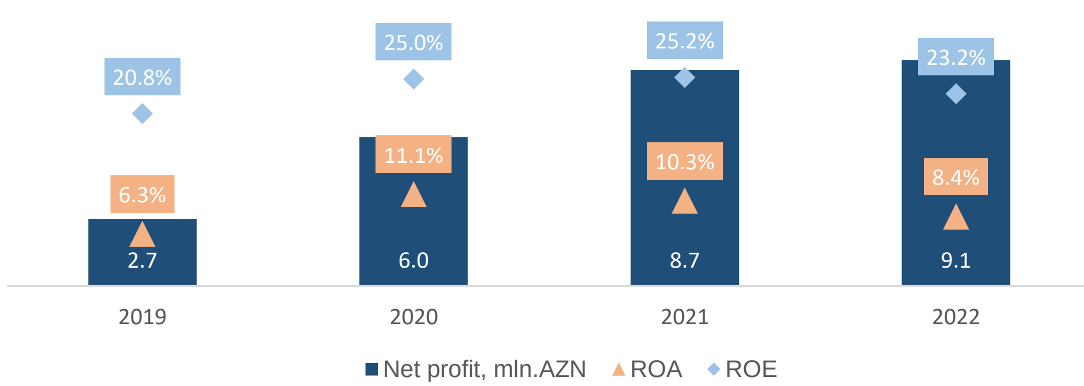
Chart 96. Structure of customer assets in terms of the types of customer assets, million AZN



Source: CBA

Profitability of investment companies continued to be positive. Net profit of investment companies increased by 4.6% (AZN0.4M) to AZN9.1M. Although profitability of the sector posted growth, growth on assets and capital was higher, allowing ROA and ROE indicators to drop to 23.2% and 8.4% respectively.

Chart 97. Profitability of investment companies



Source: CBA

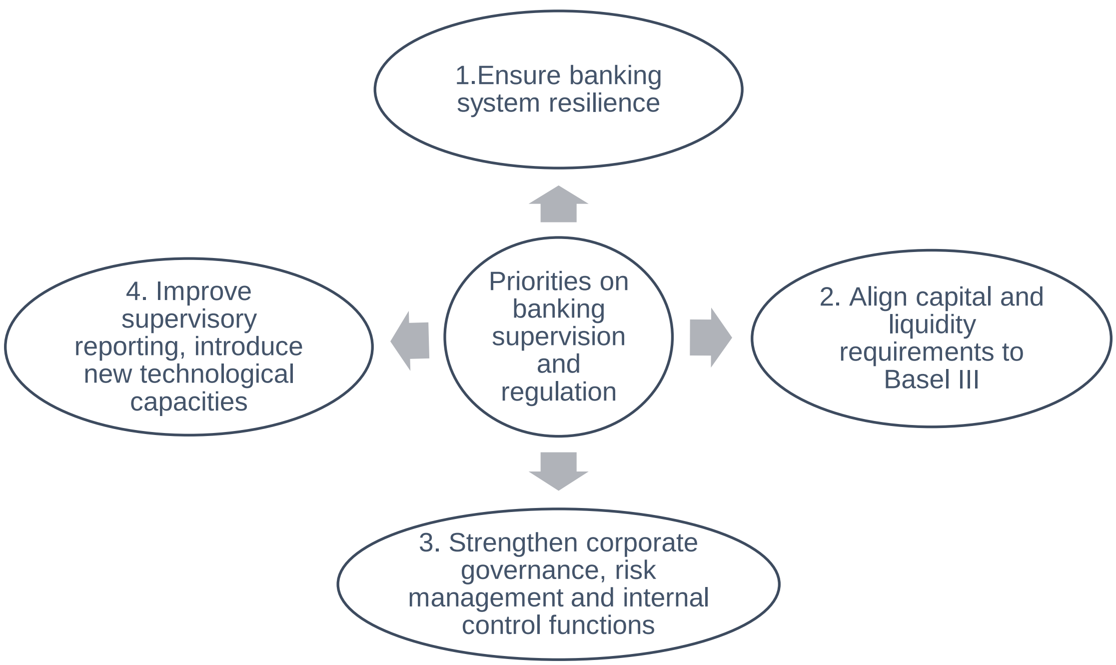
Regulatory and supervisory priorities across financial sector segments in 2023

Priorities of the CBA on regulation and supervision of the financial sector are oriented towards coverage of main risks and sensitivity zones with supervision and strengthening financial stability infrastructure.

Regulatory and supervisory priorities per segment of the financial sector for 2023 are addressed below.

- ***The banking sector***

In 2023, priorities on banking supervision and regulation will cover four directions.



1. **A flexible regulatory and supervisory response will continue amid rising external risks.** The macroeconomic background (inflation, excess borrowing of the population, etc.) will be monitored continuously, in parallel with tense supervision of **credit risk** concentration in the banking sector and individual banks and the quality of banks' lending portfolios.
   The CBA is planning to improve the regulatory framework on management of the **operational risk** taking into account digitalization of financial services, the rise in the share of remote banking services and the value of cashless payments.

At the same time, the Bank will attach great importance to forecasting and management of risks, including stress testing in banks. The CBA will continue assessing banks' access strategies and providing methodological support for banks regarding stress testing based on the quality of testing models used in stress-testing by banks and stress test findings.

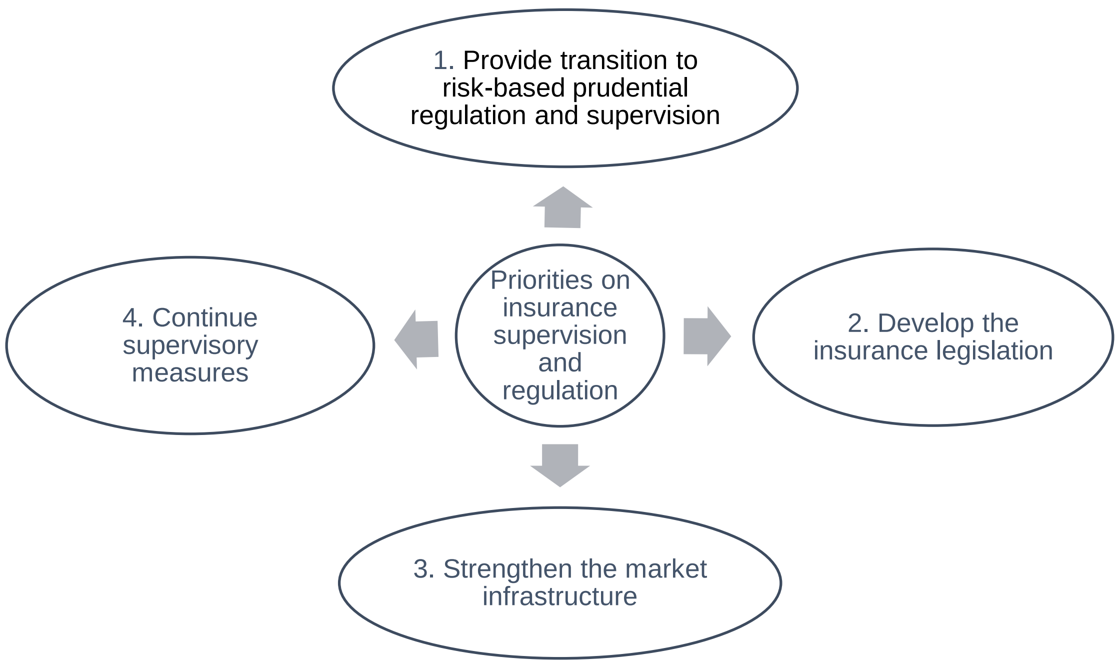
2. **Efforts will continue to align the regulatory framework to Basel III standards.** The Bank is planning to synchronize the current regulatory framework on the structure and adequacy of banks' regulatory capital structures with requirements of Basel III. The new capital structure and proposals developed on introduction of capital buffers under Basel III standards will be discussed in details in the banking sector and relevant simulations will be maintained. Alignment of the capital structure to Basel III will allow in-depth absorption of systemic risks with capital and restriction of pro-cyclicity. A new regulatory framework on liquidity management in banks is to be introduced. To more effectively measure the liquidity position, the liquidity coverage ratio based on borrower's historical behavior will be applied in line with the Basel III standards.

3. Relevant standards are being revised to **strengthen** and align **corporate governance in banks** to best practices. Updated Standards provide for revision of authorities and objectives of banks' control and management bodies, and strengthening regulatory requirements on internal control, risk management, compliance and internal audit. The Bank will focus on application of corporate governance standards, including risk management during inspections in banks.

4. Efforts will continue **to improve supervisory reporting and application of new technological options.** The current prudential reporting system is planned to be aligned to new regulatory requirements, and boost coverage and automation of the system.

- **The insurance market**

Main targets of the CBA include *protection and strengthening of insurers' financial resilience; control fair treatment of the insured as per the legislation by all insurance market participants along with insurers, improve related regulatory framework; application of state-of-art information and communication technologies; increasing quality of and access to insurance services.* The Bank is planning to implement the following four priority directions to attain targets set for the insurance sector:



1. Works planned for **transition to risk-based prudential regulation and supervision** will continue in 2023. The priority that targets maintaining insurers' financial resilience and stability, provides for strengthening insurers' investment opportunities; setting minimum requirements and norms for foreign reinsurers on coverage of risks; as well as improvement of prudential reporting on insurance and disclosure of information to public on the backdrop of improvement, higher range and access of corporate governance standards of the insurance sector.

2. The Bank is planning to maintain improvements to align the **insurance legislation** to best practices and the Insurance Core Principles adopted by major countries, and

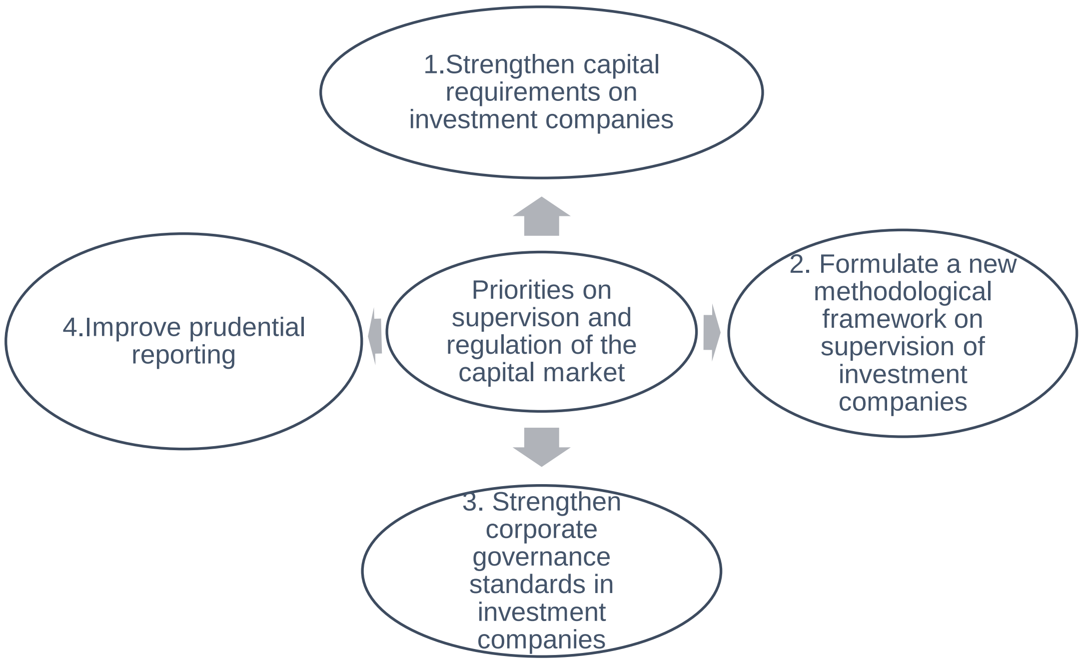
continue efforts to improve compulsory civil liability insurance for motor vehicle owners and property compulsory insurance.

3. As part of the **strengthening of the market infrastructure** efforts will continue to improve the independent expert institution, determine requirements for experts, their training and providing option for their independent selection, improve activities of insurance intermediaries, in particular insurance agents, including establishing professional development trainings.

4. Supervisory measures will be taken in 2023 to ensure operations of supervised entities under the legislation **to continue supervisory measures.** Under developed inspection plans thematic inspections will be conducted along with comprehensive inspections, also off-site inspections will be held followed by results-based enforcement and correction measures. At the same time, taking into account the fact that fair treatment of the insured and high service quality are the main factors to boost confidence in insurance, corrective measures will be taken under the legislation against market participants who failed this direction.

- ***The capital market***

The CBA is targeting to formulate a risk-based prudential regulatory and supervisory framework to protect rights of investors and safeguard capital market stability.



1. To reach the stated target the CBA is planning **to align prudential requirements** on investment companies **to best practices** in 2023. The Bank will revise requirements on minimum charter capital of investment companies, the structure and components of aggregate capital of investment companies, improve adequacy and leverage ratios, their minimum amount and calculation.

2. Moreover, the CBA will continue efforts to introduce **a** risk-based comprehensive **supervisory methodology in line with international standards** oriented towards minimizing losses in order to ensure capital market stability and sustainability.

3. The CBA will establish **corporate governance standards** for investment companies in line with best practices. The objective of establishing these standards is to organize reliable, transparent management and reporting system in investment companies on corporate governance, and ensure effectiveness of internal control and risk management.

4. **Supervisory reporting** will continue **to be improved**. It is planned to increase coverage and automation of current prudential reporting system.

Charts and tables

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