

Approved
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Board of the Central Bank of the
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Payment Systems Oversight Policy of the Central Bank of the Republic of Azerbaijan

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1. Definitions

1.1. The definitions used in the *Payment Systems Oversight Policy of the Republic of Azerbaijan* (hereinafter – the Policy) bear the following meanings:

1.1.1. **payment systems** – a funds transfer system with three or more participants, with formalized and standardized common mechanism and rules for processing, clearing and/or settlements of payment transactions.

1.1.2. **operator** – a person that organizes activities of and determines procedures for the payment system, in accordance with the *Law of the Republic of Azerbaijan on Payment Services and Payment Systems* (hereinafter – the Law).

1.1.3. **credit risk** – the risk that a payment system participant may fail to meet its financial obligations to the operator and/or other payment system participants timely and/or in full.

1.1.4. **liquidity risk** – the risk that the payment system participant will not have sufficient financial resources to meet its financial obligations.

1.1.5. **custody risk** – the risk of loss of assets held in custody arising from the insolvency, negligence, fraud, poor administration, or improper registration of securities by the legal entity responsible for the custody and safekeeping of securities.

1.1.6. **business risk** – the risk of deterioration in the operator’s financial condition as a result of a decrease in income and/or an increase in expenses.

1.1.7. **investment risk** – the risk of loss faced by the payment system operator when it or its participants invest their resources.

1.1.8. **operational risk** – the risk arising from deficiencies and errors committed by organization’s employees, problems and failures in information systems and technologies, as well as events external to the organization.

1.1.9. **principal risk** – the risk that a party holding a financial asset will not receive payment from the counterparty as a result of a value exchange.

1.1.10. **exchange-of-value settlement systems** – systems that enable the simultaneous settlement of obligations involving both foreign currency and securities.

1.1.11. **value date** – the date on which a payment transaction is executed on the participant’s account.

1.2. Other definitions used in this Policy bear the meanings specified in the Law.

2. Legal basis of the oversight of payment systems

2.1. According to Article 5.1.7 of the *Law of the Republic of Azerbaijan on the Central Bank of the Republic of Azerbaijan*, one of the functions of the Central Bank of the Republic of Azerbaijan (hereinafter – the Central Bank) is to maintain stable, safe, and effective operation of payment systems and support their development.

2.2. According to Article 46.1 of the *Law of the Republic of Azerbaijan on the Central Bank of the Republic of Azerbaijan*, the Central Bank licenses, regulates and oversees payment systems operators.

3. Principles of the payment systems oversight

3.1. The Central Bank is guided by the following key principles in carrying out oversight of payment systems:

3.1.1. **Transparency** – the Central Bank discloses its oversight policy, including the requirements for systems and the classification criteria in accordance with Clause 4.3 of this Policy, as well as the types of payment systems covered by the oversight, to the public.

3.1.2. **Compliance with international standards** – the Central Bank adopts and applies international payment system standards and principles.

3.1.3. **Authority and resources** – the Central Bank exercises the powers established by legislation to carry out its oversight function and continuously improves its organizational, technical, and human resources for conducting oversight.

3.1.4. **Continuity** – oversight standards are applied continuously to all payment systems, regardless of the operator’s legal status (public or private).

3.1.5. **Cooperation with other authorities** – the Central Bank cooperates with related public authorities and central banks of foreign states to ensure reliable and effective operation of payment systems and settlements.

3.2. The Central Bank maintains oversight of payment systems based upon the ‘**Principles for financial market infrastructures (PFMI)**’ issued by the Committee on Payments and Settlement Systems of the International Bank for Settlements (CPSS BIS) and the International Organization of Securities Commissions (IOSCO). The PFMI establishes principles with respect to operation of payment systems, as well as other financial market infrastructures.

3.3. Eighteen out of twenty-four principles of the PFMI apply to payment systems.

3.4. The principles that relate to payment systems are the following:

3.4.1. **Principle 1: Legal basis.** A payment system should have a well-founded, clear, transparent, and enforceable legal basis for each material aspect of its activities.

3.4.2. **Principle 2: Governance.** A payment system should have governance arrangements that are clear and transparent, promote its safety and efficiency, and support stability of the broader financial system, other relevant public interest considerations, and objectives of relevant stakeholders.

3.4.3. **Principle 3: Framework for the comprehensive management of risks.** A payment system should have a sound risk-management framework for comprehensively managing legal, credit, liquidity, operational, and other risks.

3.4.4. **Principle 4: Credit risk.** A payment system should effectively measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes. The payment system should maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence.

3.4.5. **Principle 5: Collateral.** A payment system that requires collateral to manage its or its participants' credit exposure should accept collateral with low credit, liquidity, and market risks.

3.4.6. **Principle 7: Liquidity risk.** A payment system should effectively measure, monitor, and manage its liquidity risk. The payment system should maintain sufficient liquid resources in all relevant currencies to effect same-day and, where appropriate, intraday and multiday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would generate the largest aggregate liquidity obligation for system in extreme conditions.

3.4.7. **Principle 8: Settlement finality.** A payment system should provide clear and certain final settlement, at a minimum by the end of the value date. Where necessary or preferable, the system should provide final settlement intraday or in real time.

3.4.8. **Principle 9: Money settlements.** A payment system should conduct its money settlements in central bank money where practical and available. If central bank money is not used, the payment system should minimize and strictly control the credit and liquidity risk arising from the use of commercial bank money.

3.4.9. **Principle 12: Exchange-of-value settlement systems.** If a payment system settles transactions that involve the settlement of two linked obligations (e.g., securities or foreign exchange transactions), it should eliminate principal risk by conditioning the final settlement of one obligation upon the final settlement of the other.

3.4.10. **Principle 13: Participant-default rules and procedures.** A payment system should have effective and clearly defined rules and procedures to manage a participant default. These rules and procedures should be designed to ensure that the payment system can take timely action to contain losses and liquidity pressures and continue to meet its obligations.

3.4.11. **Principle 15: General business risk.** A payment system should identify, monitor, and manage its general business risk and hold sufficient liquid net assets funded by equity to cover potential general business losses so that it can continue operations and services as a going concern if those losses materialize. Further, liquid net assets should at all times be sufficient to ensure a recovery or orderly wind-down of critical operations and services.

3.4.12. **Principle 16: Custody and investment risks.** A payment system should safeguard its own and its participants' assets and minimize the risk of loss on and

delay in access to these assets. Payment system's investments should be in instruments with minimal credit, market, and liquidity risks.

3.4.13. **Principle 17: Operational risk.** A payment system should identify the plausible sources of operational risk, both internal and external, and mitigate their impact through the use of appropriate systems, policies, procedures, and controls. Systems should be designed to ensure a high degree of security and operational reliability and should have adequate, scalable capacity. Business continuity management should aim for timely recovery of operations and fulfilment of the payment system's obligations, including in the event of a wide-scale or major disruption.

3.4.14. **Principle 18: Access and participation requirements.** A payment system should have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access.

3.4.15. **Principle 19: Tiered participation arrangements.** A payment system should identify, monitor, and manage the material risks to the system arising from tiered participation arrangements.

3.4.16. **Principle 21: Efficiency and effectiveness.** A payment system should be efficient and effective in meeting the requirements of its participants and the markets it serves.

3.4.17. **Principle 22: Communication procedures and standards.** A payment system should use, or at a minimum accommodate, relevant internationally accepted communication procedures and standards in order to facilitate efficient payment, clearing, settlement, and recording.

3.4.18. **Principle 23: Disclosure of rules, key procedures, and market data.** A payment system should have clear and comprehensive rules and procedures and should provide sufficient information to enable participants to have an accurate understanding of the risks, fees, and other material costs they incur by participating in the system. All relevant rules and key procedures should be publicly disclosed.

4. Payment systems oversight entities

4.1. The Central Bank classifies payment systems (oversight entities) as follows in order to implement its oversight function:

4.1.1. systemically important payment systems.

4.1.2. systemically important retail payment systems.

4.1.3. significantly important retail payment systems.

4.2. Systemic importance of oversight entities is assessed based on the degree to which their shortcomings affect stability of the national financial system.

4.3. Systemic importance of oversight entities is based on the following criteria:

4.3.1. **Types of operations:** The systems that maintain settlements on financial markets are of particular importance for the financial system of any country. Disruption in systems seriously threaten the financial system of the country as a whole.

4.3.2. **Link to other systems:** If a system is linked to other systems (e.g., for the transfer of funds to settle participants' net positions in a multilateral netting settlement system or for settlements in money and securities markets) there is a risk of the problem spreading to other financial infrastructures.

4.3.3. **Availability of alternative clearing and settlement opportunities:** If there is no alternative that allows the system to be replaced without wasting time and risking additional settlements, the system threatens financial system stability.

4.3.4. **The size and number of operations:** Total size of operations relates directly to potential loss and is an important indicator of importance of the system. At the same time, the number of operations in payment systems may be taken as an assessment factor. However, the number of operations is less important than their size.

4.3.5. **System participants:** There is potential and probability that the systems whose direct participants are financial institutions can destabilize overall financial system stability.

4.4. Based upon the criteria established with this document the Central Bank recognizes the **Real Time Gross Interbank Settlement System (AZIPS) as a systemically important payment system**. 18 principles of the PFMI (1, 2, 3, 4, 5, 7, 8, 9, 12, 13, 15, 16, 17, 18, 19, 21, 22, and 23) apply to the AZIPS. The system is used to make settlements on transactions in financial markets. System participants are banks. Taking into account the size of operations, problems likely to occur in the system may affect circulation of liquid assets in overall economy.

4.5. **The Low Value Payment Clearing and Settlement System (LVP CSS)** is recognized as **a systemically important retail payment system**. Information systems of public authorities are integrated to the LVP CSS to collect taxes, duties and other budget payments which are pooled in the centralized single account of the State Treasury Agency of the Ministry of Finance. Annually, 98% of the payments processed in payment systems by the Central Bank in terms of number are executed through the LVP CSS. 12 Principles of the PFMI (1, 2, 3, 8, 9, 13, 15, 17, 18, 21, 22, and 23) apply to the LVPCSS.

4.6. **The Instant Payments System (IPS)** is recognized as **a systemically important retail payment system**. The system ensures real-time settlements between individuals and legal entities – customers of banks and other non-bank payment service providers, as well as between these customers and public authorities. The IPS is the only interbank payment system operating 24/7, allowing users to make payments using simplified identifiers and also to use QR code payment solution. 12 Principles of the PFMI (1, 2, 3, 8, 9, 13, 15, 17, 18, 21, 22, and 23) apply to the IPS.

4.7. Payment cards are the primary cashless payment instrument used for daily consumer expenses. Considering that salaries, pensions, and other social benefits in the country are also distributed via payment cards, the **systems of operators** processing card payments are recognized by the Central Bank as **significantly important retail payment systems**. Although the number of transactions processed in these systems is high, the value of individual transactions is small, and any problems in the operation of these systems do not pose potential risks to the stability of the national financial system. The systems of operators processing card payments are assessed based on ten principles of the PFMI (1, 2, 3, 8, 13, 15, 17, 18, 19, 21, 22 and 23). Pursuant to the legislation, the Central Bank licenses payment system operators and oversees their operations.

5. Assessment

5.1. Payment systems are assessed based on the PFMI adopted by the CPSS BIS and the IOSCO.

5.2. Payment systems are assessed when:

5.2.1. the payment system operator makes changes to the rules of the system in areas like financial risks management, security and operational reliability.

5.2.2. any amendments made to the legislation are likely to affect compliance of the system with the principles.

5.3. The Central Bank assesses payment systems to discharge its regulatory and oversight functions arising from legislation. The assessment process consists of six stages:

5.3.1. identify the scope of payment systems oversight.

5.3.2. collect information to assess compliance with the principles.

5.3.3. make main conclusions for each principle.

5.3.4. issue a compliance rate per principle.

5.3.5. developing measures to address identified deficiencies based on set priorities and determine the deadline for their implementation.

5.3.6. develop an assessment report.

6. Three-stage oversight methodology

6.1. The Central Bank applies a three-stage oversight methodology to ensure effective oversight:

6.1.1. monitoring.

6.1.2. assessment.

6.1.3. making relevant changes.

6.2. Oversight is maintained as an ongoing process.

6.3. The main purpose of the monitoring process is to collect necessary information

for the oversight process. Monitoring primarily focuses on areas that pose greater risks to financial system stability, which include management, information security, financial condition, risk management, and external management (outsourcing) issues.

6.4. Information for monitoring is obtained from the following sources:

6.4.1. reports – system operators submit reports periodically.

6.4.2. system documents – this includes documents such as operational rules within the system and business continuity plans.

6.4.3. self-assessment – for this purpose, system operators complete questionnaires delivered to them. During the assessment, system operators express their position regarding compliance with the established minimum requirements.

6.4.4. audit findings – system operators submit findings of periodic audits conducted in finance and information security in accordance with legislation and regulations of the Central Bank.

6.4.5. meetings – changes in the system and information obtained from other monitoring sources are discussed in meetings with system operators.

6.5. Information obtained as a result of monitoring enables the Central Bank to assess the compliance of the payment system with the minimum requirements of the PFMI.

6.6. Compliance with minimum requirements is assessed across five categories (compliant, mostly compliant, partially compliant, non-compliant, and not applicable).

6.7. If non-compliance with the minimum requirements is identified in payment systems operated by the Central Bank, a plan of measures is developed by the structural unit conducting the assessment. The plan is implemented by the relevant structural unit of the Central Bank. Control over the implementation of the plan is conducted by the structural unit that performed the assessment.

6.8. If non-compliance with the requirements established by law is identified in other payment systems, the Central Bank issues binding requirements. If the binding requirements are not fulfilled, the Central Bank takes measures as provided by legislation.

7. Final provisions

7.1. This Policy enters into force from the date of its approval.

7.2. From the date of its approval, this Policy repeals the *Payments Systems Oversight Concept of the Central Bank of the Republic of Azerbaijan*, approved by the decision of the Management Board of the Central Bank dated 15 September 2014 (Protocol No. 20).

Taleh Kazimov

Governor

Central Bank of the Republic of Azerbaijan