

## **Regulation on prudential regulation of project financing loans**

### **1. General provisions**

This Regulation has been developed in accordance with Article 34.5 of the Law of the Republic of Azerbaijan on Banks, as well as standards of the Basel Committee on Banking Supervision and determines a regulatory framework on project financing loans in banks and local branches of foreign banks operating in the Republic of Azerbaijan (hereinafter – banks).

### **2. Definitions**

2.1. The definitions used in this Regulation bear the following meanings:

2.1.1. a project financing loan (PFL) – a business loan with the below features, issued to finance new or existing projects (e.g. energy, industry, transportation infrastructure, environment, media and communication), at least three-quarters of the repayment source and collateral of which are tied to cash flows to be generated during the project's operating phase:

2.1.1.1. the loan is granted exclusively to a legal entity established for the purpose of project implementation;

2.1.1.2. according to terms of the loan agreement, the bank has possibility to control the asset related to the financed project, including the income generated by that asset.

2.1.2 operating phase – the period when sufficient cash flows are generated for the implementation of loan liabilities on the project;

2.1.3. sponsor – a person who coordinates project related parties, monitors developments on the project, as well as provides support (material or non-material) to the project implementation;

2.1.4. a high-quality project – the project capable to fulfill its financial liabilities on time, regardless of economic conditions and negative changes in business environment, and at the same time that meets the requirements in sub items 2.1.4.1 and 2.1.4.2 or 2.1.4.1 and 2.1.4.3 herein:

2.1.4.1. the PFL includes provisions on preventing actions of the borrower that will create risk on the loan debt (e.g., increasing debt liabilities of the borrower at the expense of other sources);

2.1.4.2. 50 (fifty) percent or more of borrower's income depends on the state budget, a public authority or legal entities whose risk weight does not exceed 50 (fifty) percent, as defined in the 'Regulations on calculating bank capital and its adequacy';

2.1.4.3. a project is the project in which the state participates and (or) is specified in the state program.

2.2. Other definitions used herein bear the meanings specified in the Law of the Republic of Azerbaijan on Banks and regulations of the Central Bank of the Republic of Azerbaijan (hereinafter – the Central Bank).

### **3. Credit risk assessment**

3.1. The requirements of the Regulations should be observed in addition to the requirements specified in the 'Regulations on credit risk management in banks' when assessing credit risks on PFLs.

3.2. The bank assesses compliance of a high-quality project with the requirements specified in sub-item 2.1.4. herein at least monthly and if it is found out that these requirements have been violated, the project is not considered a high-quality project.

3.3. When issuing a PFL the bank should assess the project's earning potential, as well as cash flows, taking into account legal and/or regulatory restrictions that may apply.

3.4. When a PFL is issued, all assets related to the project, including current and future cash flows, as well as shares (stocks) of borrower's participants in borrower's equity act as securitization. In syndicated and joint loans, the agreement between lending banks should regulate the rights of each bank on securitization.

3.5. In syndicated and joint loans, where the loan will be repaid by the organizing bank, the bank acting as a participant in issuing the syndicated loan should assess stability of the organizing bank on the syndicated loan.

3.6. The PFL may be issued if the borrower:

3.6.1. has a business plan, approved by an independent expert or a company specialized in this field, covering development stages of the project, all projected costs, as well as the operating phase. An independent expert or a specialized company should have at least 3 (three) year related work experience;

3.6.2. has a contract (protocol of intent or other agreement document) with the project designer, contractor and other persons involved in the project implementation;

3.6.3. has an appropriate action plan for obtaining all permits and other legal documents necessary for the project (funds can be provided only after required permits and other legal documents have been submitted to the bank).

3.7. To evaluate the activity during loan maturity and minimize potential risks, the bank sets limits on the project in the loan agreement (e.g., deviations from planned operating costs, deviations from the schedule of works, involvement of additional debt

liabilities or availability of a guarantor, investment of cash funds, the debt-to-equity ratio, etc.) and determines measures to be taken in case of their violation (e.g., tightening of lending conditions, temporary suspension of the next tranche, etc.).

3.8. The bank should make sure that in addition to expenses provided for in the project submitted to the bank by the borrower, reserves for unexpected expenses are taken into account in cost estimate for the project. Reserves are taken into account in the credit limit or project capital.

3.9. The bank should assess creditability of the borrower, sponsors or other investors (who only make equity investments unlike sponsors) to ensure sustainability of the project against unexpected costs beyond the reserve buffer. During the assessment, at least contracts concluded with the sponsor, the guarantees given on the project, financial standing of sponsors or other investors, related experience, experience of participation in similar projects, other existing or planned projects, potential to support the project during its length should be taken into account.

3.10. The bank should have an exit strategy that reflects the cases of suspension of project financing, repayment of the debt if the debt is not repaid when the project is suspended or in other cases, including measures oriented towards the realization of the rights to securitization.

3.11. The Bank should have an employee who has at least 2 (two) year experience in project management, taking into account the nature, volume and complexity of the project to issue the PFL.

3.12. In addition to the documents and information specified in Annex 1 to the 'Regulations of Credit Risk Management in Banks', the credit file for the PFL should contain at least:

- 3.12.1. documents and information as per the criteria specified in Item 3.6 herein;
- 3.12.2. a document reflecting findings of the assessment on the criteria specified in Items 3.7 and 3.9;
- 3.12.3. the bank's exit strategy.

#### **4. Prudential regulatory framework**

4.1. Reserves on PFLs are created according to the 'Regulation on creation of special reserves for asset classification and loan loss provisioning' in light of the following requirements:

4.1.1. If the implementation of the project prior to the operating phase deviates from the period specified in the approved schedule from 180 to 360 days, the loan is classified at least as a standard asset exposed to additional risks; if the deviation exceeds 360 days, it is classified at least as an unsatisfactory asset and an appropriate reserve is created;

4.1.2. The requirements of sub-item 3.6.4.5 of the 'Regulation on creation of special reserves for asset classification and loan loss provisioning' do not apply to PFLs in the period preceding the operating phase;

4.1.3. When applying sub-item 3.6.5.3 of the 'Regulation on creation of special reserves for asset classification and loan loss provisioning', the documents in the credit file related to credit risk management should comply with the requirements herein along with the requirements of the 'Regulations on credit risk management in banks';

4.1.4. The requirements of Item 9.3 of the 'Regulation on creation of special reserves for asset classification and loan loss provisioning' do not apply to repossessed movable property on PFLs except for securities and this property is classified and provisioned from the moment of recognition:

4.1.4.1. if the market value of movable property is above its book value, it is classified at a minimum as an unsatisfactory asset at the book value within 1 (one) year;

4.1.4.2. if the market value of movable property is below its book value, it is classified at a minimum as an unsatisfactory asset at the market value 1 (one) year, whereas difference is recognized as a loss asset;

4.1.4.3. movable property is classified at least as a doubtful asset after one-year period expires;

4.1.4.4. movable property is classified as a loss asset, charged-off, and recognized in an off-balance sheet account after 2 (two) years.

4.2. Risk weights are set according to the 'Regulations on calculation of bank capital and its adequacy' in light of the following requirements to calculate bank capital and its adequacy on PFLs:

4.2.1. risk weights on national currency denominated PFLs are determined as per the below table prior to the operating phase:

	High-quality projects		Other projects	
	if equity participation is 30% or below	if equity participation is over 30%	if equity participation is 30% or below	if equity participation is over 30%
Risk weights	130%	110%	150%	130%

4.2.2. foreign currency denominated PFLs are attributed to 200% risk weight prior to the operating phase.

4.3. The equity participation ratio specified in the schedule in sub-item 4.2.1 herein is calculated with the below formula:

$$\text{Equity participation ratio} = \frac{\text{Project capital}}{\text{Project liabilities} + \text{project capital}} * 100\%$$

where:

project capital – shares (stocks) of participants in borrower’s equity;

project liabilities – borrower’s liabilities on the project due to creditors.

## **5. Final provisions**

5.1. The ‘Regulation on creation of special reserves for asset classification and loan loss provisioning’, the ‘Regulations on calculation of bank capital and its adequacy’, the ‘Regulations on credit risk management in banks’ and other regulations of the Central Bank apply in the part that does not contradict this Regulation as long as this Regulation is in force.

5.2. The bank should notify the Central Bank within 5 (five) days after the PFL is granted. The bank should deliver periodic information regarding those loan requirements to the Central Bank together with prudential reports on a monthly basis.