

Regulation on ongoing capital requirements for investment firms

1. General provisions

This Regulation has been developed in accordance with Articles 31.5 and 39.5 of the Law of the Republic of Azerbaijan on the Securities Market (hereinafter – the Law) and determines the structure and components of total regulatory capital, the leverage ratio, liquidity requirements, as well as the total regulatory capital requirement and the rules for its calculation applicable to investment firms, including branches of foreign investment firms (hereinafter – investment firms).

2. Definitions

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

2.1.1. **market risk** – the risk of losses arising from changes in market prices affecting on-balance-sheet and off-balance-sheet positions.

2.1.2. **total regulatory capital requirement** – the capital requirement as specified in Items 8.4 or 8.5 of this Regulation.

2.1.3. **multilateral development bank** – an international financial institution established by two or more countries to support economic development.

2.1.4. **operational risk** – the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

2.1.5. **commodity price risk** – the risk of losses arising from commodity price volatility.

2.1.6. **settlement risk** – the risk that a counterparty fails to fulfil its obligations to deliver cash, securities or other assets upon completion of a transaction.

2.1.7. **hybrid capital instruments** – fixed or indefinite maturity financial instruments, that combine characteristics of equity and debt, including subordinated debt instruments or other similar securities.

2.1.8. **capital surplus** – the funds obtained in the amount of the difference between the issue price and the nominal value of shares upon their placement.

2.1.9. **collective investment undertaking price risk** – the risk of losses arising from volatility in the prices of collective investment undertakings.

2.1.10. **counterparty risk** – the risk of losses arising from the failure of a counterparty to fulfil its obligations prior to the settlement of a transaction due to insolvency.

2.1.11. **concentration risk** – exposures in respect of positions in the trading book and assets outside the trading book of an investment firm to an individual client or group of

connected clients, as well as to a counterparty or a group of connected counterparties, exceeding 25% of its total regulatory capital.

2.1.12. **credit risk** – the risk of loss arising from the failure of a borrower, issuer or counterparty to meet its obligations.

2.1.13. **risk-weighted assets (RWAs)** – the value of each on-balance-sheet asset and off-balance-sheet exposure, assessed in accordance with its risk weight, after deductions.

2.1.14. **leverage ratio** – the ratio of an investment firm’s Tier 1 capital (after the deductions specified in sub-items 7.1.2 and 7.1.3 herein) to its on-balance-sheet assets.

2.1.15. **financial institutions** – legal entity credit institutions, insurers, reinsurers, insurance intermediaries, and investment firms.

2.1.16. **securitized bond** – a bond issued by a securitization special purpose vehicle, the payments under which are made from cash flows generated by underlying assets in accordance with the securitization plan.

2.1.17. **total capital** – the sum of the components (elements) included in Tier 1 (main) and Tier 2 (supplementary) capital, as defined by this Regulation, less deductions from total capital (for branches of foreign investment firms, funds deemed equivalent to total capital).

2.1.18. **intangible assets** – software, copyrights, patents, rights to use natural resources, licenses, trade and commodity marks, know-how, goodwill, and other rights without physical substance that generate value and are recognized as objects of property rights.

2.1.19. **short position** – the sale of borrowed securities, commodities or currencies with the expectation that the value of the asset will decrease.

2.1.20. **long position** – the purchase of securities, commodities or currencies with the expectation that the value of the asset will increase.

2.1.21. **equity price risk** – the risk of losses arising from changes in equity prices.

2.1.22. **specific risk for debt instruments** – the risk of price differences arising from factors related to the issuer of the debt instruments.

2.1.23. **specific position risk** – the risk of price differences arising from factors related to the issuer of the respective financial instrument.

2.1.24. **subordinated debt liabilities** – obligations which, in accordance with their terms of issuance, are repayable at maturity, are not secured by the investment firm assets, are not redeemable at the initiative of the holder, do not entitle the holder to initiate insolvency or liquidation proceedings against the investment firm in the event of non-payment (of principal, interest and/or other contractual payments) prior to maturity, and, in the event of liquidation of the investment firm, are repaid only after all claims of other creditors have been fully satisfied.

2.1.25. **trading book** – the portfolio of positions in securities or other financial instruments, as well as commodities, held by an investment firm for trading on its own account or for hedging purposes, and which are primarily exposed to market risk.

2.1.26. **K-factor requirement** – the minimum amount of capital that an investment firm is required to hold to cover risks to clients, to the market, and to the firm itself.

2.1.27. **general interest rate risk** – the risk of losses arising from changes in interest rates due to general market movements.

2.1.28. **general position risk** – the risk arising from general market movements, namely from changes in market prices in the case of equities and from changes in interest rates in the case of debt instruments

2.1.29. **foreign exchange risk** – the risk of changes in the value of an investment arising from fluctuations in foreign exchange rates.

2.1.30. **assets under management (or AUM)** – the portfolios of individual investors managed by an investment firm.

2.1.31. **assets safeguarded and administered (or ASA)** – assets in respect of which an investment firm provides securities account administration for clients, whether such assets are recorded on the balance sheet of the investment firm or in accounts with third parties.

2.2. For the purposes of this Regulation, the terms ‘connected counterparty’ and ‘group of clients’ include the persons specified in Article 49-1.1 of the Civil Code of the Republic of Azerbaijan, as well as legal entities in which a person specified in Article 49-1.1.6 of the Civil Code of the Republic of Azerbaijan directly or indirectly holds at least a 20% participation.

2.3. Other terms used in this Regulation have the meanings assigned to them in the Law and in other legal acts regulating financial markets

3. Total regulatory capital requirements

3.1. Total capital of an investment firm should support the business strategy of the investment firm and ensure its financial soundness in the event of adverse changes in the internal and external environment.

3.2. Only financial instruments paid up in cash are included in total capital.

3.3. Authorized capital of an investment firm (in the case of branches of foreign investment firms, funds deemed equivalent to authorized capital) are formed exclusively from cash contributions denominated in the national currency of the Republic of Azerbaijan.

3.4. An investment firm should, at all times during its activities, maintain total capital equal to or exceeding the total capital requirement calculated under this Regulation, as well as the minimum authorized capital established by the Central Bank of the Republic of Azerbaijan (hereinafter – the Central Bank).

3.5. Where the ratio of total capital to the total capital requirement or to the minimum authorized capital falls below 1.025, the investment firm should immediately notify the Central Bank thereof in writing.

4. The structure and management of total regulatory capital

4.1. The structure of the total capital of an investment firm consists of Tier 1 capital (main) and Tier 2 capital (supplementary).

4.2. Total capital is equal to the sum of the components included in Tier 1 and Tier 2 capital minus deductions from total capital. The components of Tier 1 and Tier 2 capital are specified in Sections 5 and 6 of this Regulation.

4.3. The Supervisory Board and the management body of the investment firm should ensure that total capital is maintained at a level which is commensurate with all risks the investment firm is exposed to and not less than the minimum level established herein.

4.4. Mechanisms should be in place for assessing the adequacy of total capital in line with the nature, scale and complexity of the investment firm's business activities and risk environment, including procedures for evaluating the potential impact of credit risk, market risk, operational risk and other risks on the total capital requirement.

4.5. The investment firm's risk management policy defines its current and future capital needs, expected capital expenditures, the desired level and structure of capital, internal and external sources of capital, as well as possibilities and timeframes for raising additional capital in the event of deterioration in the investment firm's financial condition.

5. Tier 1 capital of an investment firm

5.1. Tier 1 capital constitutes the main capital of an investment firm, and its amount (after deductions) should not be less than 50% (fifty) of the investment firm's total capital as calculated.

5.2. Tier 1 capital comprises the following components:

5.2.1. issued and fully paid ordinary shares.

5.2.2. capital surplus.

5.2.3. retained earnings (or losses) from previous years.

5.3. Retained earnings (or losses) from previous years include:

5.3.1. accumulated and undistributed profits of all prior years, excluding the loss of the current financial year.

5.3.2. capital reserves (funds established out of retained earnings from previous years).

6. Tier 2 Capital of an investment firm

6.1. The amount of Tier 2 capital included in the calculation of an investment firm's total capital should not exceed the amount of Tier 1 capital (after deductions). Any excess shall not be taken into account in the calculation of total capital.

6.2. Tier 2 capital comprises the following components:

6.2.1. profit for the current year.

6.2.2. hybrid capital elements.

6.3. To be eligible for inclusion in Tier 2 capital, hybrid capital instruments should meet the following criteria:

6.3.1. non-revocability at the creditors' request.

6.3.2. the investment firm shall have the right to defer interest payments on such instruments.

6.3.3. in the event of liquidation of the investment firm, obligations under such instruments shall be settled only after all other creditors' claims have been fully satisfied.

6.3.4. obligations under such instruments shall not be secured in any form by the assets of the investment firm.

6.3.5. the investment firm shall have the right to defer payments under such instruments where the indicators specified in Item 3.4 herein fall below the prescribed minimum levels.

6.3.6. the maturity of the principal amount of such instruments shall be at least 5 (five) years from the date of their issuance or shall be perpetual.

6.4. Hybrid capital instruments, including subordinated debt instruments, are recognized in Tier 2 capital with a reduction of 20% (twenty) per year, starting from the beginning of the first year of the remaining period when 5 (five) years remain until maturity.

7. Deductions from total regulatory capital

7.1. The following amounts are deducted from total capital:

7.1.1. ordinary shares deducted from Tier 1 capital.

7.1.2. the net carrying amount of all intangible assets, net of accumulated amortization.

7.1.3. the amount of deferred tax assets determined in accordance with the IFRS.

7.1.4. losses for the financial year.

7.1.5. investments in subsidiaries and other legal entities not reflected in the trading portfolio.

8. Calculation of ongoing capital requirement

8.1. The calculation methodology for the ongoing capital requirement of an investment firm is based on its category.

8.2. Investment firms are classified as Category I investment firms if they provide any of the following services and, excluding client assets, the arithmetic means of the total value of assets calculated at market value over the previous calendar year exceeds AZN 50,000,000 (fifty million):

8.2.1. underwriting and placement of securities on a firm commitment basis.

8.2.2. dealing on own account in securities or derivative financial instruments as a member of a central depository or stock exchange.

8.3. Investment firms not classified as Category I investment firms are classified as Category II investment firms.

8.4. The ongoing capital requirement for Category I investment firms equals the sum of capital requirements calculated for credit risk, market risk, operational risk, settlement risk, counterparty risk, and concentration risk.

8.5. The ongoing capital requirement for Category II investment firms equals the higher of the minimum amount of authorized capital, 25% (twenty-five) of operational and administrative expenses calculated on the basis of audited annual financial statements, and the K-factor requirement.

9. Capital requirement for credit risk

9.1. When calculating the capital requirement for credit risk, exposures are classified into categories under this Regulation. A risk weight is assigned to each category, and the capital requirement for credit risk is determined as 8% of the total RWAs.

9.2. The risk weight of assets is determined based on their credit quality.

9.3. Where more than one credit rating exists for a single exposure, the lowest credit rating applies.

9.4. The credit quality of exposures to foreign states and their central banks, local authorities and municipalities, financial institutions, domestic or foreign commercial entities, and investment funds, as well as of bonds issued by such issuers, and assessed by international credit rating agencies, is determined in accordance with Annex 1 herein.

9.5. Risk weights applicable to exposures to the issuers referred to in Item 9.4 and to bonds issued by them are determined in accordance with Annex 2 to this Regulation.

9.6. The risk-weight of bonds issued by legal entities, in which 51% (fifty-one) or more of the shares are owned by the state, shall be 50%.

9.7. The credit quality of securitized bonds rated by international credit rating agencies or unrated is determined in accordance with Annex 1 to this Regulation, and their risk weights are determined in accordance with Annex 3 to this Regulation.

9.8. Other on-balance-sheet assets are allocated to risk categories depending on their characteristics:

9.8.1. 0% (zero) risk category (risk weight 0.0):

9.8.1.1. government securities of the Republic of Azerbaijan, securities issued by the Central Bank, and covered securities issued by the Mortgage and Credit Guarantee Fund of the Republic of Azerbaijan (hereinafter – the Fund).

9.8.1.2. the secured portion of securities issued by multilateral development banks assigned a credit rating of 'AAA' (or equivalent) by international credit rating agencies.

9.8.1.3. the portion of an exposure unconditionally guaranteed by government securities of the Republic of Azerbaijan, guarantees of the Government or the Central Bank, or securities issued by the Central Bank.

9.8.1.4. the portion of assets secured by the national currency of the Republic of Azerbaijan.

9.8.2. 20% (twenty) risk category (risk weight 0.2):

9.8.2.1. the secured portion of securities issued by multilateral development banks not assigned to the 0% risk category and holding a minimum investment-grade credit rating assigned by international credit rating agencies.

9.8.2.2. unsecured securities issued by the Fund.

9.8.2.3. municipal bonds of the Republic of Azerbaijan.

9.8.2.4. bonds publicly offered in the Republic of Azerbaijan and admitted to trading on a regulated market.

9.8.3. 50% (fifty) risk category (risk weight 0.5):

9.8.3.1. securities issued by legal entities included in the 'List of large state-owned companies subject to preparation, approval, and monitoring of revenue and expenditure estimates', approved by Decision No. 534 of the Cabinet of Ministers of the Republic of Azerbaijan dated 30 December 2016, whose credit rating assigned by international credit rating agencies is not more than one notch below the sovereign credit rating of the Republic of Azerbaijan.

9.8.4. 100% (one hundred) risk category (risk weight 1.0):

9.8.4.1. bonds issued by foreign states, central banks of such states, central or local executive authorities, or municipalities, which have not been assigned a credit rating by international credit rating agencies.

9.8.4.2. shares not deducted from total regulatory capital of the investment firm in accordance with Part 7 of this Regulation.

9.8.4.3. shares of issuers admitted to listing on a stock exchange.

9.8.4.4. the portion of assets secured by the national currency of foreign states which have not been assigned a credit rating by international credit rating agencies.

9.8.4.5. other assets not falling under the risk categories specified in sub-items 9.8.1, 9.8.2, 9.8.3, and 9.8.5 of this Regulation.

9.8.5. 150% (one hundred and fifty) risk category (risk weight 1.5):

9.8.5.1. deferred assets.

9.8.5.2. investments in high-risk assets, including investments in newly established companies operating for less than three years.

9.8.5.3. shares of issuers not admitted to listing on a stock exchange.

9.8.6. The risk weights of other assets is determined as follows:

9.8.6.1. a risk weight of gold reserves – 0%.

9.8.6.2. a risk weight of receivables – 20%.

9.8.6.3. a risk weight of prepayments and accrued unearned income – 100%.

9.8.6.4. a risk weight of real estate and equipment – 100%.

9.9. Total RWAs for credit risk are calculated using the following formula:

$$RWA_{CR} = \sum_{i=1}^n p_i \times A_i$$

RWA_{CR} : credit risk-weighted assets (CRWA)

A_i : assets

p_i : risk weight of assets for credit risk

10. Capital requirement for market risk

10.1. The capital requirement for market risk equals the sum of capital requirements for position risk, commodity price risk, foreign exchange risk, general interest rate risk, and price risk relating to collective investment undertakings.

10.2. The capital requirement for position risk of an investment firm equals the sum of the capital requirements for equity price risk and specific risks relating to debt instruments:

10.2.1. The capital requirement for equity price risk equals the sum of the capital requirements for specific and general position risks:

$$SRK = SSr + SGr$$

SRK: capital requirement for equity price risk.

SSr: capital requirement for specific equity position risk.

SGr: capital requirement for general equity position risk.

10.2.2. To calculate capital requirements for specific and general position risk in equities, the investment firm should determine its net long positions and net short positions.

10.2.3. A net long position equals the portion of the long position in each equity instrument that exceeds the short position:

$$ELP_i > ESP_i \rightarrow ENLP_i = ELP_i - ESP_i$$

ELP_i: long position in equities.

ESP_i: short position in equities.

ENLP_i: net long position in equities.

10.2.4. A net short position equals the portion of the short position in each equity instrument that exceeds the long position.

$$ESP_i > ELP_i \rightarrow ENSP_i = ESP_i - ELP_i$$

ENSP: net short position in equities.

10.2.5. The capital requirement for specific equity position risk equals 8% of the sum of the absolute values of total net long positions and total net short positions:

$$SSr = \left(\sum_{i=1}^n |(ELP_i - ESP_i)| \right) \times 8\%$$

10.2.6. The capital requirement for general equity position risk equals 8% of the absolute value of the difference between total long positions and total short positions:

$$SGr = \left| \sum_{i=1}^n (ELP_i - ESP_i) \right| \times 8\%$$

10.2.7. The capital requirement for debt instruments equals the sum of capital requirements for specific risk and general interest rate risk relating to debt instruments:

$$CRDI = CRSR + GIIR$$

CRDI: capital requirement for positions in debt instruments

CRSR: capital requirement for specific risk relating to debt instruments.

GIIR: capital requirement for general interest rate risk.

10.2.8. The capital requirement for specific risk relating to debt instruments is calculated as follows and in accordance with Annex 4 to this Regulation:

10.2.8.1. The low-risk category applies to exposures to public authorities (public institutions) assigned a credit risk weight of 0%.

10.2.8.2. The medium risk category applies to exposures with a credit risk weight of 20% or 50%.

10.2.8.3. The high-risk category applies to exposures with a credit risk weight of 100%.

10.2.8.4. The other category applies to exposures assigned a credit risk weight of 150%.

10.2.9. Positions in debt instruments included in the trading book of the investment firm are classified in accordance with Annex 4 to this Regulation on the basis of their risk category and residual maturity, and the capital requirement is calculated by applying the relevant risk weight. The capital requirement for specific risk relating to debt instruments is calculated using the following formula:

$$CRSR = \sum_i^n DP_i DR_i$$

DP_i : positions in debt instruments.

DR_i : risk weight for debt instruments.

10.2.10. The capital requirement for general interest rate risk is calculated in accordance with Annex 5 to this Regulation.

10.2.11. Positions in the trading book of the investment firm are allocated to the table set out in Annex 5 to this Regulation according to their residual maturity and credit risk weight, and each position is calculated as the product of the relevant risk factor.

10.2.12. The capital requirement for general interest rate risk, as determined by risk weights, equals the sum of capital requirements for the overall net position, across time bands and intervals:

$$ONP = ONP + Tb + Int$$

ONP : capital requirement for the overall net position.

Tb : capital requirement by time band.

Int : capital requirement by intervals.

10.3. The capital requirement for the overall net position equals the difference between total long positions and total short positions, calculated with applicable risk factors, and is determined with the following formula:

$$ONP = \left| \sum_{i=1}^n LP_i \times R_i - \sum_{i=1}^n SP_i \times R_i \right|$$

LP_i : long position in debt instruments.

SP_i : short position in debt instruments.

R_i : risk factors applicable to debt instruments.

10.4. The capital requirement by time band is calculated only for matched positions and determined in accordance with the following formula:

$$Tb = \sum_{i=1}^n MP \times 10\%; MP = \min(LP \times R_i, SP \times R_i)$$

MP : matched position.

10.5. Positions within a given time band are matched where both long and short positions exist. In such cases, the smaller position in absolute terms constitutes the matched position, and the capital requirement is calculated on that matched position. The unmatched portion of the position equals the difference between the larger and the smaller position and is used in the calculation of the capital requirement across intervals.

10.6. The capital requirement across intervals is calculated with the following formula:

$$\begin{aligned} Int = & Int1MP \times 40\% + Int2MP \times 30\% + Int3MP \times 30\% + Int1Int2MP \times 40\% \\ & + Int2Int3MP \times 40\% + Int1Int3MP \times 150\% \end{aligned}$$

Int1MP: matched positions in the first interval

Int2MP: matched positions in the second interval

Int3MP: matched positions in the third interval

Int1Int2MP: matched positions between the first and second intervals

Int2Int3MP: matched positions between the second and third intervals

Int1Int3MP: matched positions between the first and third intervals

10.7. Where, within a given interval, both long and short positions exist across different time bands, the positions are matched. Capital requirements are determined for matched positions both within and across intervals.

10.8. The capital requirement for commodity price risk is calculated on the following:

10.8.1. precious metals (excluding gold), agricultural products, and mineral resources.

10.8.2. commodity-based derivative instruments.

10.9. When calculating the capital requirement for commodity price risk, homogeneous commodities are first identified.

10.10. Homogeneous commodities include the following:

10.10.1. positions held in sub-categories of commodities that are mutually convertible.

10.10.2. positions in similar commodities that are interchangeable, provided that the correlation between price movements of such commodities has not been less than 0.9 over at least the preceding one-year period.

10.11. The capital requirement for commodity price risk is calculated with a simplified approach. Under this approach, each commodity is expressed in a standard unit of measure and valued at the current exchange rate.

10.12. The capital requirement for commodity price risk is calculated with the following formula:

$$ComPR = \left(\sum_{i=1}^n |NP| \times 15\% \right) + \left(\sum_{i=1}^n GP \times 3\% \right)$$

ComPR: capital requirement for commodity price risk

NP: net position for commodity price risk

GP: gross position for commodity price risk.

10.13. The total net position equals, for each commodity and each homogeneous commodity, the difference between total long positions and total short positions:

$$NP_i = LP_i - SP_i$$

LP_i: long position for commodity price risk

SP_i: short position for commodity price risk

10.14. The total gross position equals, for each commodity and each homogeneous commodity, the sum of total long positions and the module value of total short positions:

$$\sum GP = (|LP_i| + |SP_i|)$$

10.15. Where the total net open position of an investment firm in foreign currencies exceeds 2% of its total regulatory capital, the capital requirement for foreign exchange risk is calculated with the following formula:

$$\sum_{i=1}^n NP > 2\%TRC \rightarrow FERC = \sum_{i=1}^n NP > 8\%$$

TRC: total regulatory capital

NP: net open position for foreign exchange risk

FERC: capital requirement for foreign exchange risk.

10.16. The total net open position is calculated as follows:

$$\sum_{i=1}^n NP = \max(NLP, NSP) + |GNP|$$

NLP: net long position for foreign exchange risk

NSP: net short position for foreign exchange risk

GNP: net position in gold.

10.16.1. Net positions are determined for each foreign currency and for gold and are expressed using the current exchange rate.

10.16.2. Total net long positions and total net short positions in foreign currencies are calculated, and the higher of the two are determined.

10.16.3. The net position in gold is determined whether it is long or short.

10.17. The following positions are excluded from the calculation of the capital requirement for foreign exchange risk:

10.17.1. long-term positions held for hedging the capital indicators of the investment firm defined in Item 3.4 of this Regulation against foreign exchange risk, where such positions are not held for trading purposes.

10.17.2. foreign exchange risk positions deducted from total regulatory capital of the firm in the calculation of total regulatory capital.

10.18. The investment firm shall notify the Central Bank of positions excluded from the calculation of the capital requirement for foreign exchange risk.

10.19. The capital requirement for price risk related to collective investments is calculated by identifying the general market risk and specific risk of positions held in the trading book, and by applying a risk weight of 16% to each net position:

$$KT_{FR} = FSr \times 16\% + FGR \times 16\%$$

$$FSr = \sum_{i=1}^n |LP_i - SP_i|$$

$$FGr = \left| \sum_{i=1}^n LP_i - \sum_{i=1}^n SP_i \right|$$

KT_{FR} : capital requirement for price risk related to collective investments

FSr : specific risk for collective investments

FGr : general risk for collective investments.

LP : long position in collective investments

SP : short position in collective investments.

11. Capital requirement for operational risk

11.1. The capital requirement for operational risk is calculated, with the formula below, as the average of the sum of investment firm's positive annual operating profit for previous 3 (three) years, based on its audited financial statements, multiplied by 15% (fifteen):

$$CROR = \frac{\sum_{i=0}^3 \max(M_i; 0)}{n} \times 15\%$$

$CROR$: capital requirement for operational risk

M_i : positive annual operating profit

n : the number of years, within the 3-year period, with positive operating profit.

11.2. Where, in any given year, the operating profit is negative or equals 0 (zero), that year is excluded from the calculation of the capital requirement for operational risk; accordingly, operating profit for that year is not included in the numerator of the formula, and that year is not counted in the denominator.

11.3. Where operating profit is negative or equals 0 (zero) in each of the preceding 3 years, the investment firm's capital requirement for operational risk is set at 0 (zero).

11.4. Operating profit is equal to the sum of the following items as reported in the statement of profit or loss and other comprehensive income set out in Appendix No. 2 to the 'Regulation on maintenance of accounting under the International Financial Reporting Standards', approved by Resolution No. Q-01 of 30 January 2017 of the Collegium of the Ministry of Finance of the Republic of Azerbaijan:

11.4.1. main operating income.

11.4.2. other operating income.

11.4.3. cost of sales (-).

11.4.4. other operating expenses (-).

12. Capital requirement for settlement risk

12.1. Where settlement in respect of transactions concluded by an investment firm on own account has not been completed, a capital requirement for settlement risk in relation to such transactions is determined.

12.2. The capital requirement for settlement risk arising from transactions concluded on a delivery-versus-payment basis is calculated, in respect of transactions carried out by

the investment firm in shares, bonds, derivative financial instruments, foreign exchange and commodities (excluding repo and reverse repo agreements and securities and commodities lending and borrowing transactions), by multiplying difference between the agreed settlement price and the current market price resulting from the failure to settle on time by settlement risk capital requirement factor determined in accordance with Annex 6 herein:

$$SCR_{SR} = PD \times SCF_i$$

SCR_{SR} : capital requirement for settlement risk

PD : difference between the agreed settlement price and the current market price

SCF_i : settlement risk capital requirement factor.

12.3. The capital requirement for settlement risk in respect of transactions not concluded on a delivery-versus-payment basis is calculated where:

12.3.1. the investment firm has made payment before receiving securities, derivative financial instruments, foreign currency or commodities, or has delivered such assets before receiving payment.

12.3.2. in relation to cross-border transactions, one or more business days have elapsed following the execution of payment or delivery by the investment firm.

12.4. The capital requirement for settlement risk in respect of transactions not concluded on a delivery-versus-payment basis is calculated as follows:

12.4.1. where, at the initial contractual stage of the transaction, neither payment nor delivery has been effected, no capital requirement applies.

12.4.2. where payment or delivery under the second leg of the transaction has been effected, but the counterparty has failed to fulfil the corresponding obligation within 4 (four) business days, the transaction is treated as a credit risk exposure, and the capital requirement is calculated in accordance with this Regulation.

12.4.3. where, from the 5th (fifth) business day following payment or delivery under the second leg of the transaction, the counterparty continues to fail to fulfil the corresponding obligation, the value of the transaction is deducted from total regulatory capital for the period commencing from that date until the maturity of the transaction.

13. Capital requirement for counterparty risk

13.1. Counterparty risk arises from the declaration of default by the counterparty prior to the settlement of a transaction, and the capital requirement for counterparty risk is calculated in respect of the following positions in the investment firm's trading book:

13.1.1. positions in derivative financial instruments.

13.1.2. positions in repo and reverse repo agreements, as well as securities and commodities lending or borrowing transactions.

13.1.3. net positions arising from margin trading transactions.

13.1.4. positions relating to transactions providing long settlement periods.

13.2. Where the counterparty risk exposure amount exceeds the collateral provided, the capital requirement for counterparty risk is calculated, with the formula below, as 8% of the risk-weighted assets corresponding to the difference:

$$R^* = \max\{0, (R_{vm} - G_{vm})\}, R > G \rightarrow CCR = \{(R_{vm} - G_{vm})R_i\} \times 8\%$$

R^* : risk-weighted assets for counterparty risk

R_{vm} : the volatility-adjusted amount of the exposure subject to counterparty risk

G_{vm} : the volatility-adjusted amount of the collateral

R_i : credit risk weight

CCR : capital requirement for counterparty risk

13.3. The volatility-adjusted amount of collateral is calculated with the formula below:

$$G_{vm} = G \times (1 - H_g - H_m)$$

G : the value of collateral

H_g : the volatility adjustment applicable to the collateral

H_m : the volatility adjustment applicable to the foreign exchange mismatch.

13.4. The volatility-adjusted amount of exposure subject to counterparty risk is calculated with the formula below:

$$R_{vm} = R \times (1 + H_r)$$

H_r : volatility adjustment applicable to exposure amount subject to counterparty risk

R : the amount of exposure subject to counterparty risk.

13.5. In the case of over-the-counter transactions in derivative financial instruments, the volatility-adjusted amount of the exposure subject to counterparty risk equals the amount of the exposure subject to counterparty risk: $R_{vm} = R$

14. Capital requirement for concentration risk

14.1. Concentration risk refers to risks arising from individual assets and liabilities that constitute a significant portion of an investment firm's regulatory capital and that may threaten the continuity of services related to proprietary trading activities. Such risks relate to a single client (or group of clients) or a counterparty (or connected counterparties).

14.2. Concentration risk includes balance-and off-balance sheet components, excluding the following:

14.2.1. deductions from the investment firm's total regulatory capital.

14.2.2. risks related to settlement within 2 (two) business days in FX transactions.

14.2.3. risks related to settlement within 5 (five) business days after payment or delivery in securities transactions.

14.2.4. cash accounts opened in the name of a client by a central depository in the course of underwriting activities carried out by the investment firm.

14.3. The investment firm should determine concentration risk exposures to an individual client/counterparty by calculating the sum of the following:

14.3.1. the portion of long positions exceeding short positions (where positive) in all financial instruments issued by the individual client/counterparty.

14.3.2. risks related to total accounts receivable of the individual client.

14.3.3. net exposures arising from the purchase of debt instruments or shares of the individual client for underwriting purposes.

14.3.4. counterparty risk exposures arising from transactions or contracts with the individual client.

14.3.5. the total of trading book and non-trading book exposures to the individual client/counterparty.

14.4. The capital requirement for a client group and related counterparties is calculated as the sum of capital requirements applicable to each individual entity within that group.

14.5. Where the capital requirement for an individual client or client group/counterparty or related counterparty exceeds 10% of Tier 1 capital, investment firms should submit the following information to the Central Bank:

14.5.1. a unique client code or a list of people comprising the client group.

14.5.2. where applicable, the value of the exposure prior to the application of credit risk mitigation techniques.

14.5.3. where used, the type of funded or unfunded credit securitization.

14.5.4. if applicable, the value of the exposure after credit risk mitigation measures.

14.6. When registering individual clients as new clients, the investment firm determines whether they belong to the same group as other clients.

14.7. The total capital requirement for an individual client or client group/counterparty or related counterparty is calculated as the sum of capital requirements arising from both the trading book and the non-trading book.

14.8. Where the concentration risk exposure to an individual client or client group/counterparty or related counterparty (excluding financial institutions) exceeds 25% of the investment firm's regulatory capital, the capital requirement is calculated as per Item 14.11 herein.

14.9. The concentration risk exposure limit to financial institutions may not exceed 100% of the investment firm's total regulatory capital.

14.10. Positions falling under the following categories are excluded from the calculation of concentration risk:

14.10.1. government securities of the Republic of Azerbaijan and securities issued by the Central Bank.

14.10.2. bonds guaranteed by the Government of the Republic of Azerbaijan.

14.10.3. bonds guaranteed by the Central Bank.

14.10.4. securities issued by international organizations of which the Republic of Azerbaijan is a member.

14.10.5. securities of foreign countries assigned a 0% credit risk weight under this Regulation, securities issued by their central banks, or obligations guaranteed by such central banks.

14.11. The investment firm should calculate the capital requirement for transactions exceeding the concentration risk limit in the trading book based on the specific risk capital requirement and, where applicable, settlement and counterparty risk capital requirements.

14.12. Where the excess exposure over the limit lasts for 10 (ten) business days or less, the additional capital requirement for concentration risk is set at 200% of the specific risk or counterparty risk capital requirement.

14.13. Where the excess exposure over the limit persists for more than 10 (ten) business days, the investment firm calculates the additional capital requirement for concentration risk as per Annex 7 herein, based on the sum of the specific risk and/or counterparty risk capital requirements for the relevant transactions.

14.14. Where the concentration risk exceeds 25% of regulatory capital, the investment firm submits a written notification to the Central Bank no later than within 2 (two) business days. This notification includes:

14.14.1. information on reasons for breach of the limit and positions contributing to it;

14.14.2. information on the measures envisaged to mitigate the risk.

15. Calculation of the capital requirement for K-factor risks

15.1. The capital requirement for K-factor risks are calculated as the sum of the following components:

15.1.1. the capital requirement for client risk factors.

15.1.2. the capital requirement for market risk factors

15.1.3. the capital requirement for investment firm risk factors.

15.2. The capital requirement for client risk factors is calculated with the following formula:

$$K-AUM + K-CMH + K-ASA + K-COH$$

K-AUM: the K-factor capital requirement for assets under management

K-ASA: K-factor capital requirement for assets safeguarded and administered

K-CMH: the K-factor capital requirement for client money held

K-COH: the K-factor capital requirement for client orders handled.

15.3. The capital requirement for market risk factors is calculated as per Part 10 herein.

15.4. The capital requirement for investment firm risk factors is calculated in accordance with the following formula:

$$K-DTF + K-TCD + K-CON$$

K-DTF: the K-factor capital requirement for daily trading flow

K-TCD: the K-factor capital requirement for trading counterparty default risk;

K-CON: the K-factor capital requirement for concentration risk.

15.5. The K-factor capital requirement for concentration risk (K-CON) is calculated in accordance with Part 14 herein.

16. K-AUM

16.1. The K-factor capital requirement for AUM is calculated as follows:

16.1.1. the aggregate amount calculated on the basis of the market value of AUM as on the last day of each month over the preceding 15 (fifteen) months is determined.

16.1.2. amounts calculated in accordance with sub-item 16.1.1 herein are converted into the investment firm's main operating currency using the end-of-day exchange rate

applicable on the last day of the relevant month, and the arithmetic mean of those amounts is calculated excluding the most recent 3 (three) months.

16.1.3. the K-factor capital requirement for AUM is calculated as the sum of the amount calculated in sub-item 16.1.2 herein and the relevant coefficient specified in Annex 8 herein.

17. K-CMH

17.1. The K-factor capital requirement for client money held (CMH) is calculated as follows:

17.1.1. the aggregate amount of CMH in the accounts of the investment firm at the end of each day over the preceding 9 (nine) months is determined.

17.1.2. the amounts calculated in sub-item 17.1.1 herein are converted into the investment firm's main operating currency using the end-of-day exchange rate applicable on the last day of the relevant month, and the arithmetic mean of those amounts is calculated excluding the most recent 3 (three) months.

17.1.3. the K-factor capital requirement for CMH is calculated as the sum of the amount calculated in sub-item 17.1.2 herein and the relevant coefficient specified in Annex 8 herein.

18. K-ASA

18.1. The K-factor capital requirement for assets safeguarded and administered (ASA) is calculated as follows:

18.1.1. the total amount calculated based on the market value of ASA by the investment firm at the end of each day over the preceding 9 (nine) months is determined.

18.1.2. the amounts calculated in sub-item 18.1.1 herein are converted into the investment firm's main operating currency using the end-of-day exchange rate applicable on the last day of the relevant month, and the arithmetic means of those amounts is calculated excluding the most recent 3 (three) months.

18.1.3. the K-factor capital requirement for ASA is calculated as the sum of the amount calculated in sub-item 18.1.2 herein and the relevant coefficient specified in Annex 8 herein.

19. K-COH

19.1. The K-factor capital requirement for client orders handled (COH) is calculated as follows:

19.1.1. the aggregate amount of COH by the investment firm at the end of each day over the preceding 6 (six) months is determined.

19.1.2. the amounts calculated in sub-item 19.1.1 herein are converted into the investment firm's main operating currency using the end-of-day exchange rate applicable on the last day of the relevant month, and the arithmetic mean of those amounts is calculated excluding the most recent 3 (three) months.

19.1.3. the K-factor capital requirement for COH is calculated as the sum of the amount calculated in sub-item 19.1.2 herein and the relevant coefficient specified in Annex 8 herein.

19.1.4. volume of client orders is calculated, in respect of cash and derivative financial instrument transactions, as the module value of purchase and sale transactions, as follows:

19.1.4.1. for transactions in securities, the amount received or paid in respect of each transaction.

19.1.4.2. total amount of transactions concluded on derivative financial instruments.

19.1.5. Orders executed within the scope of AUM are not taken into account in the calculation of the K-factor capital requirement for COH.

20. K-TCD

20.1. The K-factor capital requirement for trading counterparty default risk (TCD) applies, in the context of transactions carried out by the investment firm on own account, to the following transactions:

20.1.1. transactions in derivative financial instruments.

20.1.2. long-term settlement transactions.

20.1.3. repo transactions.

20.1.4. securities or commodities lending or borrowing transactions.

20.1.5. margin lending transactions.

20.2. The K-factor capital requirement for TCD is calculated with the formula below:

$$K\text{-TCD} = \alpha \cdot EV \cdot KR \cdot CVA$$

$\alpha = 1.2$

EV = investment firm's exposure value.

KR = the risk weight applicable to the counterparty ([Annex 9](#)).

CVA factor either 1 or 1.5, in accordance with the criteria specified in Item 20.7.

20.3. The exposure value is determined in accordance with the following formula:

$$EV = \text{Max}(0; RC + PFE - C)$$

RC = the replacement cost (Item 20.4)

PFE = potential future exposure (Item 20.5)

C = the value of collateral (Item 20.6)

20.4. The replacement cost is determined as follows:

20.4.1. for derivative financial instruments, RC is determined as the current market value of the derivative financial instrument.

20.4.2. for long settlement transactions, RC is determined as the cash settlement amount payable or receivable by the investment firm at settlement date (receivables being treated as positive and payables as negative amounts).

20.4.3. for repo transactions and securities lending or borrowing transactions, RC is determined as the amount of cash lent or borrowed (cash lent being treated as positive and cash borrowed as negative).

20.4.4. for margin lending transactions, RC is based on the carrying value of assets.

20.5. PFE, which is calculated only for derivative financial instruments, is determined for each derivative financial instrument position as the sum of the gross notional amount and the relevant supervisory factor specified in Annex 10 herein.

20.6. The value of collateral is determined as the sum of the collateral value and the relevant coefficient specified in Annex 11 herein.

20.7. The CVA factor is assigned a value of 1 in the cases and 1.5 in all other cases:

20.7.1. transactions concluded with non-financial institution counterparties.

20.7.2. transactions concluded with related parties of the investment firm.

20.7.3. long-term settlement transactions.

20.7.4. credit or other financing provided by the investment firm to investors for concluding transactions, including margin trading positions.

21. K-DTF

21.1. The K-factor capital requirement for daily trading flow (DTF), in the context of transactions carried out by the investment firm on own account, is calculated as follows:

21.1.1. the aggregate amount of the trading flow executed by the investment firm at the end of each day over the preceding 9 (nine) months is determined, and the daily average amount is calculated excluding the most recent 3 (three) months.

21.1.2. the amounts calculated in sub-item 21.1.1 are converted into the investment firm's main operating currency using the end-of-day exchange rate applicable on the last day of the relevant month, and their arithmetic means are calculated excluding the most recent 3 (three) months.

21.1.3. the K-factor capital requirement for DTF is calculated as the sum of the amount calculated in sub-item 21.1.2 and the relevant coefficient specified in Annex 8 herein.

21.1.4. the DTF is calculated, in respect of cash transactions and derivative financial instrument transactions, as the sum of absolute values of purchase and sale transactions, as follows:

21.1.4.1. for cash transactions, the amount received or paid in respect of each trade.

21.1.4.2. for transactions in derivative financial instruments, gross amount of the transaction.

21.2. For the purposes of the calculation, transactions carried out through the investment firm's account, whether on its own behalf or on behalf of its clients, is considered.

22. Requirements for and calculation of the leverage ratio

22.1. An investment firm should ensure that the leverage ratio referred to in Item 22.2 herein is maintained at a minimum level of 3%.

22.2. The leverage ratio is calculated with the following formula:

$$\text{Leverage ratio} = \frac{T_1 - TT_1}{A_i}$$

A_i : balance sheet assets

T_1 : Tier 1 Capital

TT_1 : deductions from Tier 1 Capital

23. Liquidity requirements

23.1. An investment firm should hold liquid assets at an amount at least equivalent to one-third of its operational and administrative expenses, calculated on the basis of audited financial statements for the preceding financial year.

23.2. The following asset classes are considered liquid assets:

23.2.1. cash held in cash offices of the investment firm, its representative offices and branches, as well as cash held in domestic and foreign banks and other financial institutions.

23.2.2. government bonds issued by the Republic of Azerbaijan and securities issued by the Central Bank.

23.2.3. securities issued by governments or central banks of countries with a minimum sovereign rating of 'AA-' (or equivalent) assigned by international rating agencies.

23.2.4. backed securities.

23.2.5. securities issued by multilateral development banks with a credit rating of 'AAA' (or equivalent) from international rating agencies.

23.2.6. corporate debt securities of non-financial institutions with a minimum credit rating of 'AA-' (or equivalent) from international rating agencies.

23.2.7. debt securities of non-financial institutions that are unconditionally guaranteed by the government or fully collateralized by securities accepted as collateral by the Central Bank for monetary policy operations.

23.2.8. corporate debt securities of non-financial institutions with at least an investment-grade credit rating.

23.3. When calculating liquid assets, the market value of assets as at the reporting date is taken into account.

24. Final provisions

24.1. Investment firms, within 3 (three) months from the date of entry into force of this Regulation, should determine their ongoing capital requirement as per Part 8 herein.

24.2. An investment firm should, in the first month of each calendar year, perform an assessment as per Part 8 herein to determine its category, immediately notify the Central Bank of the determined category, and ensure full compliance with the requirements of that category within the first quarter of the calendar year, taking into account the requirements of Item 24.3 herein.

24.3. Where, in the course of the annual assessment referred to in Item 24.2 herein, an investment firm previously assigned to a category under Part 8 is determined to fall under a different category, and the change in category would, for the first time, result in a reduction of the investment firm's total capital requirement, the change of category is not allowed. Where, in the subsequent annual assessment, the result remains the same as in the previous year, the investment firm is assigned to the new category notwithstanding any reduction in the total capital requirement, and in such case should ensure full compliance with the requirements of the new category within the first quarter of the calendar year.

Annex № 1 to the 'Regulation on ongoing capital requirement for investment firms'

Credit ratings assigned by international credit rating agencies

Credit quality category	Credit rating		
	Fitch Ratings	Moody's Investors Service	Standard and Poor's Rating Services
1	from AAA to AA-	from Aaa to Aa3	From AAA to AA-
2	from A+ to A-	from A1 to A3	from A+ to A-
3	from BBB+ to BBB-	from Baa1 to Baa3	from BBB+ to BBB-
4	from BB+ to BB-	from Ba1 to Ba3	from BB+ to BB-
5	from B+ to B-	from B1 to B3	from B+ to B-
6	CCC+ ≥	Caa1 ≥	CCC+ ≥

Risk weights

Credit quality category	Foreign states or their central banks (sovereign debt)	Local and municipal authorities of foreign states	Financial institutions (for exposures with a contractual maturity exceeding 3 months)	Financial institutions (for exposures with a contractual maturity of less than 3 months)	Corporates, Investment Funds
1	0%	20%	20%	20%	20%
2	20%	50%	50%	20%	50%
3	50%	100%	50%	20%	100%
4	100%	100%	100%	50%	100%
5	100%	100%	100%	50%	150%
6	150%	150%	150%	150%	150%
Unrated	100%	100%	100%	50%	150%

Annex № 3 to the 'Regulation on ongoing capital requirement for investment firms'

Risk weights for securitized bonds

Credit quality category	1	2	3	4	5	6	Unrated
Risk weight	25%	50%	100%	350%	1250%	1250%	1250%

Annex № 4 to the 'Regulation on ongoing capital requirement for investment firms'

Table for the calculation of capital requirements for specific risk on debt instruments

Risk categories	Residual maturity (months)	Credit risk weight	Risk weight for debt instruments (%)
Low risk		0%	0
Medium risk	< 6	20%, 50%	0,25
	6 – 24		1
	> 24		1,60
High risk		100%	8
Other		150%	12

Annex № 5 to the 'Regulation on ongoing capital requirement for investment firms'

Table for the calculation of capital requirements for general interest rate risk

Intervals	Payment limit		Risk weight for bonds (%)		
	3% or more interest rate	less than 3%			
Interval 1	Time band	0 ≤ 1 month	Time band	0 ≤ 1 month	0,00
		> 1 ≤ 3 months		> 1 ≤ 3 months	0,20
		> 3 ≤ 6 months		> 3 ≤ 6 months	0,40
		> 6 ≤ 12 months		> 6 ≤ 12 months	0,70
Interval 2		> 1 ≤ 2 years		> 1,0 ≤ 1,9 years	1,25
		> 2 ≤ 3 years		> 1,9 ≤ 2,8 years	1,75
		> 3 ≤ 4 years		> 2,8 ≤ 3,6 years	2,25
Interval 3		> 4 ≤ 5 years		> 3,6 ≤ 4,3 years	2,75
		> 5 ≤ 7 years		> 4,3 ≤ 5,7 years	3,25
		> 7 ≤ 10 years		> 5,7 ≤ 7,3 years	3,75
		> 10 ≤ 15 years		> 7,3 ≤ 9,3 years	4,50
		> 15 ≤ 20 years		> 9,3 ≤ 10,6 years	5,25
	> 20 years	> 10,6 ≤ 12,0 years	6,00		
		> 12,0 ≤ 20,0 years	8,00		
	> 20 years	12,50			

Annex № 6 to the 'Regulation on ongoing capital requirement for investment firms'

Table
for the calculation of capital requirements for settlement risk
on delivery-versus-payment transactions

Number of business days elapsed since the settlement date	Capital requirement factor for settlement risk (%)
5-15	8
16-30	50
31-45	75
46 or more	100

Annex № 7 to the 'Regulation on ongoing capital requirement for investment firms'

Table for the calculation of capital requirements for concentration risk

Capital requirement for exposures exceeding the concentration risk limit	Weight
up to 40%	200%
from 40% to 60%	300%
from 60% to 80%	400%
from 80% to 100%	500%
from 100% to 250%	600%
over 250%	900%

Annex № 8 to the 'Regulation on ongoing capital requirement for investment firms'

Table for the calculation of K-Factor requirements

K-factor requirement	Coefficient
K-AUM	0.02%
K-CMH	0.5%
K-ASA	0.04%
K-COH	0.1%
K-DTF	0.1%

Annex № 9 to the 'Regulation on ongoing capital requirement for investment firms'

Table of counterparty risk weights

Type of counterparty	Risk weight
Central governments, central banks and public sector entities	1.6%
Credit institutions and investment firms	1.6%
Other counterparties	8%

Annex № 10 to the 'Regulation on ongoing capital requirement for investment firms'

Supervisory Factor Table

Asset class	Supervisory factor
Interest rate	0.5%
Foreign currency	4%
Loan	1%
Capital	32%
Capital index	20%
Commodity/issuance allowance	18%
Other	32%

Annex № 11 to the 'Regulation on ongoing capital requirement for investment firms'

Volatility Adjustment Table

Asset class		Volatility factor for repo transactions	Volatility factor for other transactions
Debt securities issued by central governments or central banks	< 1 years	0,707 %	1 %
	>1 year < 5 years	2,121 %	3 %
	> 5 years	4,243 %	6 %
Debt securities issued by other entities	< 1 year	1,414 %	2 %
	>1 year < 5 years	4,243 %	6 %
	> 5 years	8,485 %	12 %
Securitization positions	< 1 year	2,828 %	4 %
	>1 year < 5 years	8,485 %	12 %
	> 5 years	16,970 %	24 %
Equities and convertible securities		14,143 %	20 %
Other securities and commodities		17,678 %	25 %
Gold		10,607 %	15 %
Cash		0 %	0 %