

24 April 2020

## **Regulations on calculation of bank capital and its adequacy**

### **1. General provisions**

1.1. These Regulations have been developed according to Articles 21.1, 34.2.1, 34.2.2 and 34.2.3 of the ‘Law of the Republic of Azerbaijan on Banks’ (hereinafter – the Law).

1.2. These Regulations determine the structure and components of total regulatory capital, its adequacy and leverage ratios and their minimum amount and procedures for calculation thereof for banks and local branches of foreign banks (hereinafter – ‘banks’) operating in the Republic of Azerbaijan.

### **2. Definitions**

2.1. The definitions used in these Regulations bear the following meanings:

2.1.1. total regulatory capital (funds equated to the paid-in capital for local branches of foreign banks) – the capital used for prudential reporting, the difference between the sum of the components (elements) that comprise Tier I (main) and Tier II (additional) capital defined herein, and deductions applied to them.

2.1.2. risk-weighted assets (RWA) – the value of on-balance sheet assets and off-balance sheet liabilities calculated as per their individual risk weights after deductions.

2.1.3. capital adequacy ratio – the ratio of Tier I capital and total regulatory capital to individually risk-weighted assets calculated as per the formulae established herein.

2.1.4. counter-cyclic capital buffer – the buffer comprising Tier I capital established by the Central Bank of the Republic of Azerbaijan (hereinafter – the Central Bank) in line with the economic cycle and the dynamics of lending portfolio.

2.1.5. credit conversion factor – the ratio that allows to convert bank's off-balance sheet liabilities to on-balance sheet asset values.

2.1.6. general reserves for possible asset losses – the reserves established to cover possible losses on bank's standard assets.

2.1.7. specific reserves for possible asset losses – the reserves established to cover possible losses on bank's sub-standard assets.

2.1.8. hybrid capital elements – term and perpetual financial instruments that combine characteristics of equities and debt liabilities, including cumulative and non-cumulative perpetual preferred stock, subordinated debt liabilities or other similar securities.

2.1.9. non-cumulative perpetual preferred stock – preferred stocks, that *entitle* the issuer to decide against paying out dividends to stockholders, as well as do not entitle stock owners to claim previously unpaid dividends (if terms and conditions of the issuance stipulate an alteration of dividend amounts in connection with market conditions and the bank's financial standing, such equities are not recognized as non-cumulative indefinite/perpetual preferred stock).

2.1.10. cumulative perpetual preferred stock – equities where dividends unpaid to holders are regularly accumulated and paid out prior to dividend payouts on non-cumulative perpetual

preferred stock and ordinary/common stock as well as where the issuer is entitled to defer dividend payouts for a certain period.

2.1.11. subordinated debt liabilities – liabilities, payable upon maturity, not secured with bankable assets, not redeemable at holder's option, do not carry the right to claim bank's bankruptcy or liquidation if not paid until maturity (*principal debt or interest on principal debt and/or other payments specified in the agreement*) under terms and conditions of the issue, and, in case of the bank's liquidation, are handled after depositor claims and debt liabilities of bank's other creditors have been satisfied in full.

2.1.12. share premium (hereinafter capital surplus) – funds gained as a result of spread between market and nominal values of ordinary or preferred stock during their placement.

2.1.13. intangible assets – software, copyrights, patents, rights to utilize natural resources, licenses, trademarks, know-how, goodwill, and other rights that exist in no physical form yet add value, recognized as the subject of property rights.

2.1.14. the leverage ratio – the ratio of the bank's Tier I (after deductions in sub-item 81.1. herein) capital to balance sheet assets and off-balance sheet liabilities, excluding the portion, guaranteed with pledged deposits in the national currency of the Republic of Azerbaijan, foreign currency, or bank metals.

2.1.15. off-balance sheet liabilities – guarantees, warranties and similar contingencies, loan instruments (outstanding portions of liabilities on credit lines and similar credit liabilities) and letters of credit.

2.1.16. market value of securities – the price of securities formed in financial markets as a result of interaction of supply and demand.

2.1.17. consumer loan – loan, *including credit lines*, issued to individuals for the purposes not related to entrepreneurial or professional activity, as well as purchase or construction of real estate.

2.1.18. business loan – loan issued to legal entities and unincorporated individuals for entrepreneurial purposes, as well as agriculture loans, *as well as agriculture loans*.

2.1.19. bank acceptance – document specifying bank's acceptance or guarantee to execute short-term debt liabilities.

2.1.20. multilateral development bank (MDB) – international financial institution founded by two or more countries to encourage economic development.

~~2.1.21. debt to income ratio (DTI) – borrower's monthly debt on consumer loans to his/her monthly income (on individuals in a group of borrowers their total monthly debt to their total income).~~

~~2.1.22. non-performing loan (NPL) – outstanding amount of a loan 90 (ninety) calendar days delinquent from the date specified in the contract or payment schedule on unpaid portion of principal, or interest, or any of them.~~

~~2.1.23. non-performing amount of microcredits – a portion of principal payments over 90 (ninety) calendar days delinquent from a contractual date of a microcredit, guaranteed by the Agrarian Credit and Development Agency under the Ministry of Agriculture of the Republic of Azerbaijan (hereinafter – the Agency).~~

2.2. Other definitions used herein bear the meanings specified in the Law of the Republic of Azerbaijan 'on Banks' and regulations arising from the Law.

2.3. For the purposes of this Regulation, a credit line means the bank's obligation, under the bank account agreement, to extend credit (credit the account) for the execution of payments notwithstanding the absence of funds in the customer's account (excluding any obligations arising independently of the customer's intent to borrow or the credit institution's intent to lend, including but not limited to those resulting from exchange rate fluctuations or technical malfunctions occurring during clearing).

### **3. The purpose of total regulatory capital and related requirements**

3.1. The main objective of total regulatory capital is to support bank's business strategy and maintain its financial sustainability during unfavorable changes in domestic and foreign environment. It serves to reduce possible losses that may cause the bank to lose its solvency and increase depositors' and potential investors' confidence in the banking system.

3.2. Minimum amount of total regulatory capital should be AZN 50 (fifty) million.

3.3. Total regulatory capital includes financial instruments only payable with funds.

3.4. According to the requirements of Items 21.2 and 21.3 of the Law, no bank may, without the Central Bank's prior written approval, reduce total regulatory capital by paying the value of equities when selling or reducing the nominal value of equities, as well as no foreign bank may reduce local branch's funds equated to the total regulatory capital by withdrawing the funds equated to paid-in capital.

3.5. According to Item 21.4 of the Law, inputs to paid in capital of banks (fund equated to the paid-in capital for a local branch of a foreign bank) are made in the national currency of the Republic of Azerbaijan.

3.6. Minimum amount of paid-in capital (funds equated to paid-in capital for a local branch of a foreign bank) for newly established banks should be AZN 50 (fifty) million.

### **4. Capital management**

4.1. Supervisory and Management Boards should ensure that the bank's total regulatory capital is appropriate to its risk exposure and maintain its minimum amount and adequacy ratios as defined herein.

4.2. Assessment of bank's capital in accordance with its business activity and features of risk environment and mechanisms to identify its level, including procedures to evaluate potential impacts of credit, market, operational and other risks on capital adequacy should be in place.

4.3. A risk management policy includes current and future demand for capital, expected capital expenditures, a desired level and structure, internal and external sources of capital, as well as opportunities and periods to attract additional capital if the bank's financial stance deteriorates.

4.4. The bank assesses the impact of its risk exposure and risk exposure volatility on bank's earnings, total regulatory capital, and capital adequacy. With the frequency the bank defines, the assessment is conducted by using stress tests or other risk management methods considering features of bank's risk. The assessment at least covers:

4.4.1. identify, measure all significant risks, and evaluate their impact on bank's total regulatory capital adequacy.

4.4.2. assess whether the bank attained capital adequacy targets.

4.4.3. evaluate main assumptions used in the total regulatory capital assessment system.

4.4.4. evaluate bank's future demand for total regulatory capital based on bank's risks and identify necessity for relevant changes to the risk management policy if needed.

4.5. To maintain total regulatory capital adequacy, bank's capital and relevant risk management processes are analyzed on the following directions:

4.5.1. how efficient the total regulatory capital assessment process is, given the nature, scope, and complexity of the bank's activity.

4.5.2. adequate linkage of significant risks to bank's total regulatory capital.

4.5.3. accuracy and completeness of the information used during assessment.

4.5.4. how justified and reliable assumptions, models and scenarios used in assessment are.

4.6. Findings of assessment and analysis conducted under Items 4.4 and 4.5 herein are submitted to the Supervisory Board as specified in internal reporting regulations.

4.7. Total regulatory capital assessment and management processes are evaluated by internal audit at least annually and findings are reported to the Supervisory Board.

## **5. Structure of the total regulatory capital**

Total regulatory capital consists of Tier one (I) and Tier two (II) capital. Components of Tier I and Tier II capital are defined in Items 6 and 7 herein.

### **6. Tier I Capital**

6.1. Tier I capital is the bank's core capital, and its amount should not fall below 50 percent of bank's estimated total regulatory capital (after deductions).

6.2. Tier I capital includes:

6.2.1. fully paid common stock issued to circulation (excluding repossessed shares).

6.2.2. fully paid non-cumulative preferred perpetual stock issued to circulation.

6.2.3. capital surplus.

6.2.4. net retained earnings from previous years.

6.3. Net retained earnings from previous years include:

6.3.1. accumulated retained earnings from previous years, less current year losses.

6.3.2. capital reserves, i.e., accounts established from retained earnings of previous years.

### **7. Tier II Capital**

7.1. Tier II capital is supplementary capital. Tier II capital's share in bank's calculated total regulatory capital may not exceed Tier I capital (after deductions). Any portion more than the said level is not included in calculation of total regulatory capital.

7.2. Tier II capital includes:

7.2.1. profit from the current year.

7.2.2. total reserves (a portion up to 1.25 percent of risk-weighted balance sheet assets and off-balance sheet liabilities (after deductions), that do not exceed general reserves).

7.2.3. capital's hybrid elements except for non-cumulative perpetual preferred stock.

7.3. To incorporate capital's hybrid elements specified in sub-item 7.2.3 herein to Tier II Capital they should meet at least the following criteria:

7.3.1. irrevocable upon creditors claim.

7.3.2. bank should be entitled to defer interest payments on such instruments.

7.3.3. liabilities for such instruments have the last priority in case of bank liquidation.

7.3.4. liabilities for such instruments are not guaranteed by assets of bank by any means.

7.3.5. in case capital adequacy indicators fall below the threshold established herein, the bank should be entitled to defer payments on such instruments.

7.3.6. the execution period of principal amount of bank's liabilities on these instruments should be set for at least after 5 (five) years after the day of liability, or under perpetual conditions.

7.4. Capital's hybrid elements, including subordinated debt liabilities are recorded in Tier II Capital with 20 percent decrease per year starting from the beginning of the first year of the remainder period, 5 (five) years until maturity.

7.5. The amount of capital's hybrid elements considered in calculation of Tier II Capital should not exceed 50 (fifty) percent of Tier I Capital (after deductions).

## 8. Deductions from capital

8.1. The following is deducted from capital before calculating capital adequacy or leverage ratios (deductions are made):

8.1.1. from Tier I capital — all net intangible assets (including amortization) and amount of deferred tax assets as set in the International Financial Reporting Standards.

8.1.2. from total regulatory capital — equity investments in subsidiaries, as well as other legal entities (excluding specific reserves established for these investments).

## 9. Risk groups of assets

9.1. Banks assign various risk weights to on-balance sheet assets and off-balance sheet liabilities depending on their type, nature, and securitization of the liability.

9.2. Where assets and off-balance sheet liabilities are backed with securities, the market value of securities is considered in calculation of risk weights.

9.3. Balance sheet assets are assigned risk weights based on the following characteristics:

9.3.1. 0 percent (0.0 ratio) risk weight:

9.3.1.1. the national currency of the Republic of Azerbaijan in bank's cash offices, vaults, its representative offices, divisions and branch offices, ATMs and currency exchange offices, as well as in transit, bank metals, currency of countries with minimum 'AA-' sovereign debt rating (or equivalent) assigned by international rating agencies (Standard & Poor's, Fitch Ratings, Moody's, hereinafter – international rating agencies), as well as securities issued by and direct claims on governments and central banks of such countries, *or a portion of the asset unconditionally secured by governments or central banks of these countries.*

9.3.1.2. funds in bank's accounts (correspondent, deposit, etc.) held with the Central Bank, as well as Repo deals concluded with the Central Bank.

9.3.1.3. direct claims on contracts signed on behalf of the Republic of Azerbaijan, government securities and securities issued by the Central Bank.

9.3.1.4. mortgage securities issued by the Azerbaijan Mortgage and Credit Guarantee Fund (hereinafter – the Fund).

9.3.1.5. portion of a loan secured with the national currency of the Republic of Azerbaijan pledged in bank's accounts, bank metals or currency of the countries with minimum 'AA-' sovereign debt rating (or equivalent) issued by international rating agencies.

9.3.1.6. direct claims against MDBs with 'AAA' credit rating (or equivalent) issued by international rating agencies, or the portion of claims secured with unconditional liability or securities issued by these institutions.

~~9.3.1.7. a portion of loans granted to entrepreneurs in manat under the guarantee of the Fund, non-performing portion of which accounts for up to 5% of total portfolio, secured by the Republic of Azerbaijan or the Central Bank.~~

9.3.1.8. Mortgage loans issued with the guarantee of the Fund.

9.3.1.9. *a portion of the asset unconditionally secured with government securities of the Republic of Azerbaijan, government guarantee, as well as securities issued by the Central Bank.*

9.3.1.10. *student education loans issued from the funds of the Education Student Loan Fund under the Ministry of Education of the Republic of Azerbaijan (except for the cases where the bank bears financial liability).*

9.3.2. 20 percent (0.2 ratio) risk weight:

9.3.2.1. currency of the countries with minimum 'A-' sovereign debt rating (or equivalent) issued by international rating agencies, as well as securities issued by governments and central banks of these countries and direct claims against them, not included to the 0 (zero) risk group.

9.3.2.2. deposit with the minimum 'AA-' credit rating (or equivalent) issued by international rating agencies or claims against other financial credit institutions and other assets unconditionally secured by them.

9.3.2.3. a portion of claims backed with securities issued by local authorities or municipalities of the countries with the minimum 'AA-' country (sovereign) debt rating (or equivalent) issued by international rating agencies (such claims should be paid from total budget receipts rather than from proceeds from commercial projects).

9.3.2.4. direct claims against MDBs with the minimum investment rating issued by international rating agencies not included to the 0 (zero) risk group or the portion of the claims secured with unconditional commitment or securities issued by these institutions.

9.3.2.5. all assets or any portion thereof, if they are secured with securities issued by a third party and in its turn, the repayment of such securities is unconditionally guaranteed by the Republic of Azerbaijan, the Central Bank, or governments or central banks of the countries with the minimum 'A-' sovereign debt rating (or equivalent) issued by international rating agencies.

9.3.2.6. a portion of debts of third parties to the bank, not included to the 0 (zero) risk group and unconditionally guaranteed by the Republic of Azerbaijan, the Central Bank, or governments or central banks of the countries with the minimum 'A-' sovereign debt rating (or equivalent) issued by international rating agencies.

9.3.2.7. non-backed securities issued by the Fund.

9.3.2.8. *the unconditionally secured portion of business, including agriculture loans issued in manat with the guarantee of funds created by the state and guaranteeing the fulfillment of liabilities on bank loans and other specialized public institutions.*

~~9.3.2.9. a secured portion of microcredits issued under the guarantee of the Agency, the non-performing portion of which accounts for up to 12% of the outstanding portfolio.~~

9.3.2.10. ~~long term~~ corporate securities with the minimum 'AA-' credit rating (or equivalent), issued by international rating agencies.

9.3.2.11. ~~short term corporate securities with the minimum 'A-1' credit rating (or equivalent), issued by international rating agencies.~~

9.3.3. 35 percent (0.35 ratio) risk weight:

9.3.3.1. mortgage loans issued out of money of the Fund.

9.3.3.2. *claims against local banks (banks operating in the Republic of Azerbaijan and local branches of foreign banks), whose credit rating is maximum of 3 (three) rates lower than the country (sovereign) debt rating of the Republic of Azerbaijan with a term not exceeding 6 (six) months (excluding restructured assets).*

9.3.4. 50 percent (0.5 ratio) risk weight:

9.3.4.1. currency of countries not included to 20 (twenty) percent risk weight with minimum investment rating issued by international rating agencies, as well as securities issued by governments or central banks of these countries and claims against them.

9.3.4.2. claims against deposit or other financial credit institutions not included to 20 (twenty) percent risk weight with the minimum 'A-' credit rating (or equivalent) issued by international rating agencies.

9.3.4.3. a portion of claims secured with securities issued by local authorities, or municipalities of the countries with the minimum 'A-' sovereign debt rating (or equivalent) issued by international rating agencies not included to 20 (twenty) percent risk weight (these claims are paid from income generated on commercial projects).

9.3.4.4. mortgage loans issued from bank's funds and other sources.

9.3.4.5. ~~long term~~ corporate securities with the minimum 'A-' credit rating (or equivalent), issued by international rating agencies.

9.3.4.6. ~~short term corporate securities with the minimum 'A 2' credit rating (or equivalent), issued by international rating agencies.~~

9.3.4.7. securities issued by legal entities specified in the 'List of state companies whose income and expenditure estimates should be prepared, approved and monitored for implementation' approved by Resolution of the Cabinet of Ministers of the Republic of Azerbaijan No. 534 dated 30 December 2016 with the credit rating issued by international rating agencies that fall at most 1 (one) rate below the sovereign credit rating of the Republic of Azerbaijan.

9.3.4.8. national currency denominated business, *including agriculture loans* not included to the 20 (twenty) percent risk weight, issued to small and medium-sized businesses determined by the related legislation of the Republic of Azerbaijan, whose use for intended purpose is confirmed with relevant documents.

9.3.4.9. national currency denominated business loans not included to the 20 (twenty) percent risk weight, oriented towards financing of (non-oil) export, whose use for intended purpose is confirmed with relevant documents.

9.3.4.10. *claims against local banks (banks and local branches of foreign banks functioning in the Republic of Azerbaijan) not included to the 35 (thirty-five) percent risk weight with a term not exceeding 6 (six) months (excluding restructured assets).*

9.3.5. 75 percent (0.75 ratio) risk weight:

9.3.5.1. foreign currency denominated business loans oriented towards financing of (non-oil) export, whose use for intended purpose is confirmed with relevant documents.

9.3.5.2. *national currency denominated agriculture loans issued to micro businesses not attributed to 20 (twenty) percent risk weight.*

9.3.6. 100 percent (1.0 ratio) risk weight:

9.3.6.1. claims secured with securities issued by the Nakhchivan Autonomous Republic, local authorities, or municipalities of the Republic of Azerbaijan.

9.3.6.2. ~~long term~~ securities not included to 50 (fifty) percent risk weight, with minimum 'BB-' credit rating (or equivalent) issued by international rating agencies or not rated.

9.3.6.3. all fixed assets, including fixed assets not used in banking.

9.3.6.4. payment instruments in the process of collection (executed by, but not reimbursed to the bank).

~~9.3.6.5. a secured portion of entrepreneur loans issued in manat under the Fund's guarantee the non-performing portion of which accounts for over 5% of total portfolio.~~

~~9.3.6.6. a secured portion of microcredits issued under the guarantee of the Agency, the non-performing portion of which accounts for 12% and more of the outstanding portfolio.~~

9.3.6.7. other assets not included to risk weights specified in sub-items 9.3.1, 9.3.2, 9.3.3, 9.3.4, 9.3.5, ~~9.3.7, 9.3.8, 9.3.9, 9.3.10 and 9.3.11~~ herein.

9.3.6.8. *claims against local banks (banks and local branches of foreign banks operating in the Republic of Azerbaijan) not included to the 35 (thirty-five) and 50 (fifty) percent risk weight.*

9.3.6.9. *national currency denominated agriculture loans to family farms not attributed to 20 (twenty) percent risk weight.*

~~9.3.7. 120 (hundred and twenty) percent (1.2 ratio) risk weight:~~

~~9.3.7.1. foreign currency denominated business loans, excluding business loans issued to borrowers who have foreign currency income.~~

9.3.8. 150 (hundred and fifty) percent (1.5 ratio) risk weight:

9.3.8.1. ~~long term~~ corporate securities with below 'BB-' credit rating (or equivalent) issued by international rating agencies.

~~9.3.8.2. consumer loans with over 45 (forty five) — 60 (sixty) percent DTI (excluding consumer loans secured with cash funds in national and hard currencies, whose value of collateral does not fall below 100 (one hundred) percent of the commitment it secures, as well as consumer loans secured with real estate and vehicles, whose value of collateral does not fall below 150 (one hundred and fifty) percent of the commitment it secures).~~

~~9.3.8.3. consumer loans, whose interest rate at the time of issuance is greater than the sum of the average interest rate of consumer loans on the sector issued during the previous quarter and the one third of it. Average interest rate on consumer loans is calculated by the Central Bank as per Annex 1 herein and disclosed on the official website of the Central Bank until the 25th day of the month following every quarter. Banks are informed electronically or by postal notification within 1 (one) business day following the date the average interest rate is disclosed. Until average interest rate is disclosed, banks use data of the previous quarter.~~

~~9.3.9. 180 (hundred and eighty) percent (1.8 ratio) risk weight:~~

~~9.3.9.1. consumer loans with over 60 (sixty) percent, but not higher than 70 (seventy) percent DTI (excluding consumer loans secured with cash funds in national and hard currencies, whose value of collateral does not fall below 100 (one hundred) percent of the commitment it secures, as well as consumer loans secured with real estate and vehicles, whose value of collateral does not fall below 150 (one hundred and fifty) percent of the commitment it secures).~~

~~9.3.9.2. consumer loans, whose interest rate at the time of issuance is greater than the sum of the average interest rate on sector's consumer loans issued during the previous quarter and the half of it.~~

~~9.3.10. 200 (two hundred) percent (2.0 ratio) risk weight:~~

~~9.3.10.1. consumer loans, whose DTI ratio is over 45 (forty five), but do not exceed 60 (sixty) percent or over 70 (seventy) percent (excluding consumer loans secured with cash funds in national and hard currencies, whose value of collateral does not fall below 100 (one hundred) percent of the commitment it secures, as well as consumer loans secured with real estate and vehicles, whose value of collateral does not fall below 150 (one hundred and fifty) percent of the commitment it secures).~~

~~9.3.10.2. consumer loans whose interest rates are higher than the sum of the average interest rate of the sector on consumer loans issued in the previous quarter and its quarter at the time of issuance. An average interest rate on consumer loans is calculated by the Central Bank as per Annex 1 herein and disclosed on the official website of the Central Bank until the 25th day of the month following every quarter. Banks are informed electronically or by postal notification within 1 (one) business day following the date the average interest rate is disclosed. Until average interest rate is disclosed, banks use data of the previous quarter.~~

~~9.3.10.3. excluding business loans issued to borrowers who have income in foreign currency or whose currency risk is hedged otherwise, business loans in foreign currency issued to borrowers whose currency risk is not hedged.~~

~~9.3.11. 230 (two hundred and thirty) percent (2,3 ratio) risk weight:~~

~~9.3.11.1. consumer loans whose DTI ratio is over 60 (sixty) but does not exceed 70 (seventy) percent.~~

~~9.3.11.2. consumer loans whose interest rates are higher than the sum of the average interest rate of the sector on consumer loans issued in the previous quarter and its one third at the time of issuance.~~

9.4. In case a consumer loan corresponds to conditions of several diverse risk weights, the loan is included to the highest risk weight it corresponds. Risk weights are increased as follows depending on maturity and currency of consumer loans:

9.4.1. risk weight of loans with 3 year or more and 5 year or less maturity is increased by 20 basis points (bp).

9.4.2. risk weight of loans with over 5 year or more and 7 year or less maturity is increased by 40 bp.

9.4.3. risk weight of consumer loans in foreign currency is increased by 60 bp.

9.4-1. *The risk weight of the loans issued under the behavioral model established in the 'Regulation on credit risk management in banks' approved by Resolution No 46/4 of the Management Board of the Central Bank dated 21 September 2023 is increased by 20 bp.*

9.5. To risk weigh off-balance sheet liabilities (assets), outstanding amount of off-balance sheet liabilities is multiplied by the credit conversion factor defined in Items 9.6 and 9.7 herein, and the resulting amount is deemed the on-balance sheet equivalent of the off-balance sheet liability and this amount is assigned to the relevant risk weight set for on-balance sheet assets under Item 9.3 herein.

9.6. Off-balance sheet liabilities specified herein are converted to a loan under the ratios established below:

9.6.1. off-balance sheet liabilities, *except for consumer loan lines*, with up to one year maturity – at 20 (twenty) percent (credit conversion factor – 0.2).

9.6.1-1. *consumer loan lines – at 40 (forty) percent (credit conversion factor – 0,4).*

9.6.2. off-balance sheet liabilities, *except for consumer loan lines*, with over one year maturity – at 50 (fifty) percent (credit conversion factor – 0.5).

9.6.3. liabilities on trading of bank acceptance and securities – at 100 (one hundred) percent (credit conversion factor – 1.0).

9.6.4. liabilities that entitle the bank to unilaterally not discharge its obligations in full or partially on a contractual basis, *except for consumer loan lines* – at 0 (zero) percent (credit conversion factor – 0).

9.6-1. *the unused portion of consumer credit lines (recorded in off-balance-sheet accounts), after being converted into a credit in accordance with sub-item 9.6.1-1 herein, are assigned a 100% risk weight.*

9.7. FX agreements (forward agreements) are converted to credit using the below ratios:

Forward contracts concluded for the duration of the underlying agreement (the original period stated in the contract for purchase of currency)	Credit conversion percentage or factor
a) one year and less	2 % or 0,02
b) from one year up to two years	5 % or 0,05
c) over two years. 3% for each subsequent year after the third year («n» is the number of years)	5 %+3 % x n or 0,05+0,03 x n

To convert the forward agreement amount into an a balance sheet asset, the appropriate credit conversion factor in the table is multiplied by the contract value, and the resulting amount is deemed on-balance sheet equivalent of the off-balance sheet liability and is thereafter assigned to a relevant risk weight defined for on-balance sheet assets in Item 9.3 herein.

## 10. Deductions from assets

Before calculating risk-weighted assets specific reserves for possible asset losses, as well as Tier I capital and deductions from regulatory capital are deducted from the assets (deductions).

## 11. Minimum capital requirement on market risks

11.1. For the purposes of these Regulations market risks include only the currency risk the bank is exposed to.

11.2. Market risk weighted assets are equal to absolute expression of the aggregate open currency position *calculated on an average monthly basis* established under the 'Regulations on setting open currency position limits in banks.'

11.3. If the aggregate open currency position accounts for 2% or more of bank's total regulatory capital, it is considered in full in market risk evaluation, if it accounts for less than 2% of bank's total regulatory capital, is set as 0 (zero).

## **12. Minimum capital requirement on operational risks**

12.1. Operational risk weighted assets are calculated by dividing the capital requirement on operational risks by the regulatory capital adequacy ratio set in Items 13.1 and 13.2 herein by means of the following formula:

$$RWA (OR) = \frac{OR}{AR}$$

where: OR – capital requirement on operational risks, AR – total regulatory capital adequacy ratio.

12.2. The capital requirement on operational risks is calculated via the following formula with the base indicator approach and equals to the average denominator of the sum of bank's positive annual operating profit over past 3 years multiplied by 15 (fifteen) percent:

$$OR = \frac{\sum_{i=1}^n (M * 15\%)}{n}$$

where: OR - capital requirement on operational risks, M –positive annual operating profit over past 3 years, n - the number of years with positive operating profit on a three-year period.

12.3. When calculating capital requirement on operational risks, on the year the operating profit is negative or equals zero, operating profit for that year is ignored in the numerator, and the year is ignored in the denominator.

12.4. If operating profit is negative or equals 0 (zero) every year over past three years, bank's capital requirement on operational risks is set as 0 (zero).

12.5. Operating profit equals to the sum of bank's net interest and net non-interest income and specific reserves created on interest debts *and/or other payments specified in the agreement*.

12.6. Gains and losses from trading of other securities, as well as income generated from unexpected types of activities, including insurance activity are not included to the calculation of operating profit, except for securities recognized in bank's daily report on aggregate income (income statement).

## **13. Requirements on and calculation of capital adequacy ratios**

13.1. Other banks, except for systemically important banks, should maintain total regulatory capital adequacy ratio not less than 10 (ten) percent.

13.2. The total regulatory capital adequacy ratio of systemically important banks may not fall below 12 (twelve) percent.

13.3. Other banks, except for systemically important banks, should maintain Tier I capital adequacy ratio not less than 5 (five) percent.

13.4. The Tier I capital adequacy ratio of systemically important banks may not fall below 6 (six) percent.

13.5. Depending on the economic cycle and lending portfolio growth rate, 0 – 2.5% counter-cyclic capital buffer is added to the Tier I and regulatory capital adequacy ratio. Calculation of the counter cyclic capital buffer is established under *Annex 2* herein.

13.6. The total regulatory capital, risk-weighted assets and capital adequacy ratios are calculated using the following formulae:

13.6.1. Aggregate capital

$$= \mathbf{T}_1 - \mathbf{TT}_1 + \mathbf{T}_2 - \mathbf{MT}$$

where:  $T_1$  – Tier I capital,  $TT_1$  – deductions from Tier I capital,  $T_2$  – Tier II capital,  $MT$  deductions from total regulatory capital.

13.6.2. Risk weighted assets are calculated with the below formula:

$$\mathbf{RWA} = \mathbf{BA} + \mathbf{OBL}$$

$$\mathbf{BA} = \sum_i RD_i * (BA_i - E_i)$$

$$\mathbf{OBL} = \sum_i \sum_j KK_j * (OBL_j - E_j) * RD_{ij}$$

where:  $RWA$  – risk weighted assets,  $BA$  – risk weighted balance assets,  $OBL$  – risk weighted off-balance sheet liabilities,  $RD_i$  –  $i$  risk weight on assets,  $BA_i$  – balance assets corresponding to  $i$ -risk weight,  $E_i$  – deductions from balance assets corresponding to  $i$ -risk weight,  $KK_j$  –  $j$  credit conversion factor,  $OBL_j$  – execution amount of off-balance sheet liabilities corresponding to  $j$  credit conversion factor,  $E_j$  – deductions from off-balance sheet liabilities corresponding to  $j$  credit conversion factor,  $RD_{ij}$  – risk weight of  $i$ -balance item after multiplying by  $j$  credit conversion factor.

13.6.3. Tier I capital adequacy ratio

$$= \frac{\mathbf{T}_1 - \mathbf{TT}_1}{\mathbf{RWA}(\mathbf{Cr}) + \mathbf{RWA}(\mathbf{Mr}) + \mathbf{RWA}(\mathbf{Or})} \times 100\%$$

where:  $T1$  – Tier I capital,  $TT1$  – deductions from Tier I capital,  $RWA(\mathbf{Cr})$  – risk weighted assets on the credit risk,  $RWA(\mathbf{Mr})$  – risk weighted assets on the marker risk,  $RWA(\mathbf{Or})$  – risk weighted assets on the operating risk.

13.6.4. Total regulatory capital adequacy ratio

$$= \frac{\mathbf{TC}}{\mathbf{RWA}(\mathbf{Cr}) + \mathbf{RWA}(\mathbf{Mr}) + \mathbf{RWA}(\mathbf{Or})} \times 100\%$$

Where: *TC* – total regulatory capital, *RWA(Cr)* – risk weighted assets on the credit risk, *RWA(Mr)* – risk weighted assets on the marker risk, *RWA(Or)* – risk weighted assets on the operating risk.

13.7. When calculating Tier I capital and total regulatory capital adequacy ratios market and operating risk weighted assets are considered from 1 January 2021 onward.

#### **14. Requirements on and calculation of the leverage ratio**

14.1. Other banks, except for systemically important banks, should maintain the leverage ratio at a level not less than 4 (four) percent.

14.2. The leverage ratio of systemically important banks may not fall below 5 (five) percent.

14.3. The outstanding amount of off-balance sheet liabilities to be considered in the leverage ratio is converted to a credit with the ratios established below:

14.3.1. off-balance sheet liabilities with up to one year maturity – at 20 (twenty) percent (credit conversion factor – 0.2).

14.3.2. off-balance sheet liabilities with over one year maturity – at 50 (fifty) percent (credit conversion factor – 0.5).

14.3.3. liabilities on trading of bank acceptance and securities – at 100 (one hundred) percent (credit conversion factor – 1.0).

14.3.4. liabilities, that entitle the bank to unilaterally not discharge its liabilities in full or partially on a contractual basis – at 10 (ten) percent (credit conversion factor – 0.1).

14.4. Leverage ratio

$$= \frac{\text{Tier I capital} - \text{deductions from Tier I capital}}{\text{balance sheet assets} + \text{off} - \text{balance sheet liabilities}} \times 100\%$$

14.5. Deposit foreign exchange swap transactions are considered in the leverage ratio being netted in the following cases:

14.5.1. when total amount of transactions with up to one year maturity account for less than 10 (ten) percent of total assets.

14.5.2. when total amount of transactions with over one year maturity account for less than 15 (fifteen) percent of total assets.

14.5.3. when total amount of deposit foreign exchange swap transactions account for less than 15 (fifteen) percent of total assets.

14.6. During netting bank's deposits placed with another bank are not considered in the amount of liabilities due to that bank under swap transaction conditions.

14.7. The following conditions should be met to net funds:

14.7.1. placed deposit funds are blocked for the bank that places these funds.

14.7.2. placed deposit acts as collateral for attracted funds.

#### **15. Final provisions**

~~These Regulations take effect after being published on electronic version of the State Register of Legal Acts of the Republic of Azerbaijan.~~

### Calculation of an average interest rate of the sector on consumer loans

1. The Central Bank calculates an average interest rate of the sector on consumer loans in the following sequence:

1.1. Average interest rates are obtained from every bank on the following types of consumer loans issued over the previous month:

- 1.1.1. car loans
- 1.1.2. credit card loans
- 1.1.3. home repair loans
- 1.1.4. home appliance loans
- 1.1.5 other consumer loans

1.2. A sector median is established per consumer loan based upon generated average interest rates.

2.  $j$  average interest rate per consumer loan type issued by every bank in particular currency in the previous quarter (on that bank) is calculated as follows:

$$P_j = \frac{\sum_{k=1}^m (L_{jk} \times I_{jk})}{\sum_{k=1}^m L_{jk}}$$

where:

$P_j$  – average interest rate of loans per  $j$  consumer loan type issued by the bank in particular currency in the previous quarter

$L_{jk}$  –  $k$  number of loan amount issued by the bank in particular currency in the previous month per  $j$  consumer loan type

$I_{jk}$  – interest rate of the  $k$  number of loan amount issued by the bank in particular currency in the previous month per  $j$  consumer loan type

$j$  – type of a consumer loan

$k$  – serial number of a loan,  $k = \{1, 2, \dots, m\}$

$m$  – total number of loans per  $j$  consumer loan type.

3. A bank delivers an average interest rate calculated as per Annex 1 herein to the Central Bank together with the data underlying the calculations jointly with prudential reports in the form established by the Central Bank.

4. Where other payments are specified in the loan agreement instead of interest, the sum of those payments are considered in the calculation of the average interest rate.

### **Calculation and disclosure of the counter-cyclic capital buffer**

1. A credit gap acts as a main indicator for creating a counter-cyclic capital buffer.
2. Credit gap is the difference between the credit-to-GDP ratio over a particular period and its long-term trend.
3. 10-year indicators are considered when calculating a long-term trend of the credit-to-GDP ratio. A Hodrick-Prescott filter is used to identify the trend, while the smoothing parameter ( $\lambda$  - lambda) may be set 1,600 or 400,000.
4. When as a main indicator the credit gap ranges 2-10%, the counter-cyclic capital buffer is defined within the 0-2.5% range with the below formula (as per Item 5 to this Annex):

$$\text{Counter-cyclic capital buffer} = \text{Min} \left( 2.5\% \times \frac{\text{Max}(\text{Credit gap} - 2\%, 0)}{10\% - 2\%}, 2.5\% \right)$$

5. When setting a counter-cyclic capital buffer, the following indicators are considered along with the credit gap:
  - 5.1. real GDP growth
  - 5.2. growth in return on banking sector equity
  - 5.3. banking sector losses
  - 5.4. deviation of real estate and stock market indicators from long-term trend
  - 5.5. difference between return on same maturity government and corporate securities.
6. If the required capital buffer rate is increased, this requirement takes effect after *at least 1 (one)* month from the date the requirement is announced, while decrease of the requirement takes effect from the date of announcement.