CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

Risk-Based Supervision Policy Concept of the Central Bank of the Republic of Azerbaijan

APPROVED
by Resolution No.47 of the
Management Board of
Central Bank of
the Republic of Azerbaijan
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Contents

Definitions

Supervised Entities	Financial institutions specified in Article 46.1 of the Law of the Republic of Azerbaijan "On the Central Bank of the Republic of Azerbaijan" (hereinafter - the Law)
Supervisory Intervention Measures	Impact measures, corrective actions, sanctions, and mandatory instructions applied to supervised entities
Initial Rating of Supervised Entity	Rating determined by supervisors based on quantitative assessment of risk indicators during the risk assessment and supervision intensity determination phase, and approved by the Director of the Supervision Department
Final Rating of Supervised Entity	Rating determined based on quantitative and qualitative assessment of risk indicators and approved by the Supervision Committee
Supervisors	Employees of the Central Bank of the Republic of Azerbaijan and heads of structural units (departments, divisions) conducting external and internal supervision
Systemic Risk	Risk of crisis emergence in the financial sector due to chain reaction spreading of problems arising in the operations of one or more financial market participants
Institutional Profile	Document covering general and historical information about each supervised entity (shareholder structure, business model, management, etc.), including its initial rating (final rating after updates), and supervisor's notes regarding the risks of that supervised entity
Supervision Strategy	Document prepared for each supervised entity based on its institutional profile, covering planned supervisory activities for the next year, information obtained from media and sector, and assessment of resources required for supervision. The supervision strategy also includes supervisors' assumptions about the supervised entity's activities for the next three years.
Annual Supervision Plan	Plan covering planned inspections of supervised entities, required resources, and external service needs for the next year
Supervision Priorities of the Central Bank of the Republic of Azerbaijan	Document with minimum content determined by this concept, reflecting the supervision strategy for the entire financial sector for the next three years

1. General provisions

1.1. Purpose of the Policy Concept

"The Risk-Based Supervision Policy Concept of the Central Bank of the Republic of Azerbaijan" has been developed within the framework of "Financial Sector Development Strategy for 2024-2026," and its main purpose is to achieve the implementation of a risk-based supervision approach for entities defined as supervised entities. The Concept aims to serve as a primary guide for supervisory establishment work and other documents while ensuring public awareness, particularly of supervised entities, about the new supervision approach.

The Concept has been developed based on the Basel Committee on Banking Supervision's documents on early warning systems, the European Union Supervisory Authority's regulations and methodological guidelines on the Supervisory Review and Evaluation Process (SREP), as well as progressive country practices in insurance supervision and the principles of the International Organization of Securities Commissions (IOSCO). The Concept encompasses the risk-based supervision cycle, its elements, risk rating system, along with the organizational structure of risk-based supervision and its relationships with other supervisory functions of the Central Bank of the Republic of Azerbaijan (hereinafter - the Central Bank). Within this framework, the Central Bank's mission is to ensure the stability and sustainability of financial markets, manage systemic risk within the macroprudential supervision framework, and reduce potential threats.

The document also covers relevant methodologies (instructions) approved by the Central Bank that should be applied during supervision processes and defines its relationship with other ongoing projects.

The risk-based approach to be implemented by the Central Bank for supervised entities is called ARAS (Azerbaijan Risk Assessment System).

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1.2. Purpose of risk-based supervision

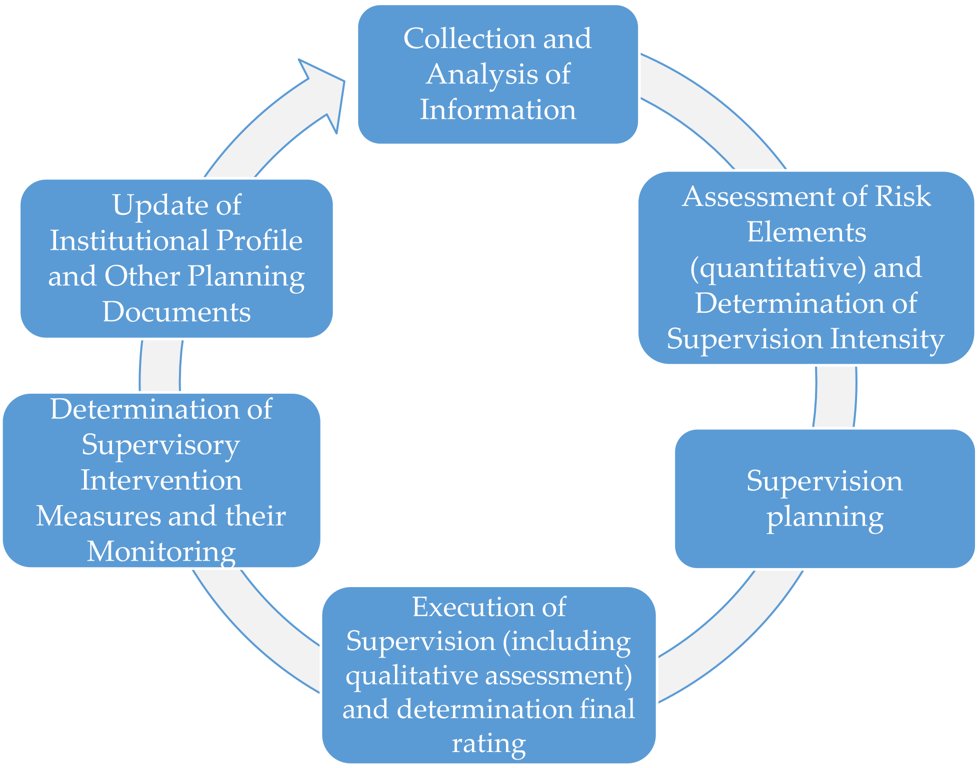
The Central Bank's risk-based supervision aims to achieve the following by ensuring the establishment of a supervision framework focused on the main risks of the financial sector:

- Minimization of systemic risk. By applying this supervision approach, the Central Bank aims to prevent systemic risk by intensifying supervision of entities that could cause systemic risk. This approach contributes to the country's economic stability by strengthening the financial sector's resilience;
- Selection of proactive and effective supervisory intervention. Risk-based supervision enables early risk identification and preventive measures before problems arise, rather than reactive measures;
- Efficient use of supervisory resources. In the risk-based supervision approach, more attention is given to supervised entities with high-risk profiles, ensuring more effective and efficient allocation of supervisory resources;
- Proportional supervision based on risk profiles: Implementation of risk-based supervision reduces the supervisory burden on low-risk profile entities in accordance with the proportionality principle;
- Ensuring sound risk management. In the risk-based supervision approach, the risk rating of a supervised entity and corresponding supervisory tools directly depend on the quality of the entity's risk management. This necessitates the formation of advanced risk management and internal control in these entities;
- Ensuring flexibility in the supervision process. The increase in cybersecurity, Environmental, Social and Governance, and other risks in the financial sector requires agile adaptation from both supervised entities and the supervisory authority. The flexibility of the risk-based supervision approach ensures faster integration of new risks into the supervision process;
- Effective coordination of supervision with regulation. Focus on key risks and selection of preventive supervisory measures also leads to more proactive macroprudential policy decisions;
- Alignment with international standards. The establishment of risk-based supervision, which is an approach applied by progressive supervisory authorities and recommended by international organizations, ensures increased confidence in the country's financial sector.

2. ARAS supervision cycle and its components

The ARAS supervision cycle includes structured and periodically recurring supervisory activities. The description of the supervision cycle is shown in Diagram 1.

Diagram 1. ARAS supervision cycle



2.1. Data Collection and Analysis

Bu At this stage, information about the supervised entity is collected and analyzed from internal and external information sources.

Internal information sources refer to the following information received from supervised entities during the supervision process and analyzed by supervisors:

- Prudential and financial reports
- External audit reports, external auditor's letters to the supervised entity
- Inspection reports
- Information disclosed to the public regarding the supervised entity's annual activities
- Reports from the supervised entity's internal control functions
- Correspondence with the supervised entity
- Memoranda related to monitoring of supervisory intervention measures applied to the supervised entity
- Reports on the supervised entity's activities, etc.

External information sources primarily include:

- Central Bank's Monetary Policy reviews
- Central Bank's Financial Stability report
- Risk analysis reports for each sector
- Materials submitted to the Monetary Policy and Financial Stability Committee
- Information about inspection results, sanctions, and other measures applied by other state bodies
- International rating agencies' reports
- Summarized results of market conduct supervision and anti-money laundering and countering the financing of terrorism (AML/CFT) supervision
- Rating agencies' reports
- Articles published in international economic journals about the country's financial sector
- Media information

The results of data collection and analysis are used in assessing the risks of the supervised entity, determining (preparing) its institutional profile, risk rating, and supervision strategy documents.

2.2. Risk elements assessment and determination of supervision intensity

The risk assessment of a supervised entity includes the analysis of quantitative indicators appropriate to its sector and determination of initial rating. Each indicator is assigned weight degrees specified in supervision guidelines. At the same time, each indicator consists of various sub-indicators that have been assigned weight degrees. When calculating indicators, each sub-indicator is multiplied by these weight degrees and summed.

For quantitative assessment, evaluation ranges from 1 to 4, where 1 is considered the best indicator and 4 is the worst indicator.

In the banking example, these indicators are i) credit risk, ii) market and investment risk, iii) operational risk, iv) business model and profitability, v) management and risk management, vi) capital management, vii) liquidity risk management. For each sector, supervision guidelines specify indicators, sub-indicators, their weight degrees, procedures for conducting quantitative and qualitative assessments, as well as weight degrees for quantitative and qualitative components when necessary. Risk assessment is the primary tool for determining supervision intensity and planning supervision. The outcome of this cycle is the determination of supervision intensity based on the matrix (Table 1 and Diagram 2) compiled based on the initial rating determined by supervisors and approved by the director of the relevant Supervision department for each sector, and the categorization of the supervised entity. The categorization of the supervised entity and the number of categories are determined in supervision guidelines according to their systemic importance or market share. In the banking example, categorization is conducted according to the bank's systemic importance index in accordance with the normative act regarding criteria for determining systemically important banks.

Table 1. Determination of supervision intensity

Categorization of Supervised Entities Based on Their Systematic Importance or Market Share	Grouping of Supervised Entities According to Risk Rating (ARAS)				
	Low	Medium	Higher than Medium	High	Very high
Category 1					
Category 2					
Category 3					

Diagram 2. Supervision intensity stages

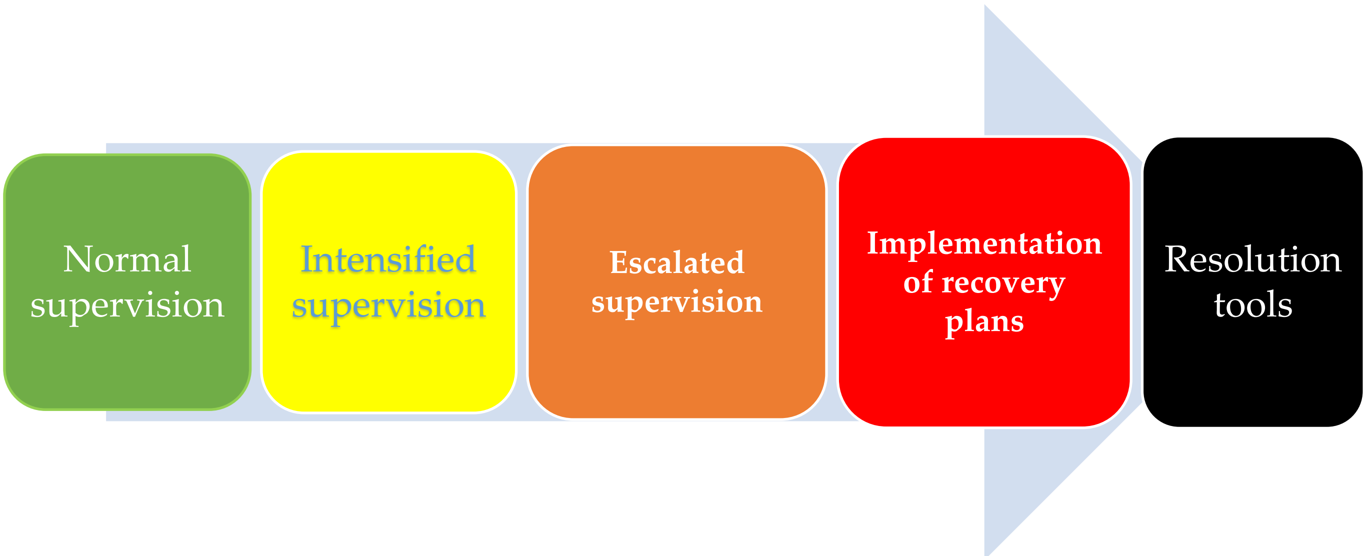


Table 1 and Diagram 2 are provided in the banking example and may be defined differently in supervision guidelines for other supervised entities.

The minimum required level of contact/dialogue and reporting for each supervision intensity is given in Table 2, and details will be specified in supervision guidelines.

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Table 2. Example of Minimum Required Contact/Dialogue and reporting level by Supervision Intensity

Supervisory Intensity	Minimum Contact/Dialogue Level	Minimum Reporting
Normal Supervision Regime	Annual meetings with the Management Board and its committees (depending on the sector requirements of the supervised entity) and the head of the internal audit department. Semi-annual meetings with the executive body and the heads of second-line defense departments (risk management, compliance, and other relevant functions).	Quarterly prudential reports, monthly financial reports, etc.
Intensive Supervision Regime	Bi-annual meetings with the Management Board and its committees (depending on the sector requirements of the supervised entity) and the head of the internal audit department. Quarterly meetings with executive body members and monthly meetings with the heads of second-line defense departments (risk management, compliance, and other relevant functions).	Monthly prudential reports, monthly financial reports, weekly balance change reports, etc.
Enhanced Supervision Regime	Quarterly meetings with the Management Board and its committees (depending on the sector requirements of the supervised entity) and the head of the internal audit department. Monthly meetings with executive body members and heads of second-line defense departments (risk management, compliance, and other relevant functions).	Monthly prudential reports, monthly financial reports, daily balance change reports, etc.

Execution of Recovery Plans	Quarterly meetings with the Management Board and its committees (depending on the sector requirements of the supervised entity) and the head of the internal audit department. Monthly meetings with executive body members and heads of second-line defense departments (risk management, compliance, and other relevant functions).	Monthly prudential reports, monthly financial reports, daily balance change reports, and recovery plan execution reports.
Resolution Measures	Decisions on next steps are made at the Supervisory Committee, taking into account the proposals of the Resolution Department.	

2.3. Supervision planning

The planning phase of the supervision cycle begins with the formation of a supervision strategy based on the institutional profile prepared by supervisors for each supervised entity. The supervision strategy for each supervised entity is updated by the first business day of September each year and summarized by the directors of supervision departments by the first business day of October.

Based on individual supervision strategies, supervision departments prepare a draft annual supervision plan. During the preparation of the draft plan, the planning of internal and external supervision activities is carried out based on the categorization of the supervised entity (as shown in Table 3). The prepared plan is jointly agreed upon by the directors of supervision departments and submitted to the Supervision Committee by the first business day of the second week of October. After the draft plan is reviewed by the Supervision Committee, it is submitted to the Management Board for approval by the first business day of November. The Annual Supervision Plan is approved by the Management Board by the first business day of the second week of November.

The draft of the "Central Bank's supervision priorities" document is jointly agreed upon by the directors of supervision departments and submitted to the Supervision Committee for review by the first business day of December. The Supervision Committee must submit the Document to the Management Board for approval by the first business day of the second week of December. The Document, covering a three-year period, is approved by the Management Board by the last business day of December and is reviewed annually with amendments made when necessary. The "Central Bank's supervision priorities" document includes at least the following:

1. Main trends and risks in the financial sector during the period;
2. Strategic supervision priorities of the Central Bank;
3. Challenges to be faced in implementing strategic priorities;
4. Report on the implementation of the previous document.

Table 3. Planning of External Supervision Analyses and Internal Supervision Inspections in Banking Example

Bank Category	Updating rating based on off-site activities	Thematic or comperhensive examination
Systemically important banks	Monthly	Every 12 monthes
Medium banks	Monthly	Every 18 monthes
Small banks	Quarterly	Every 24 monthes

2.4. Implementation of Supervision and Determination of Final rating

The main purpose of the implementation phase is to establish the final rating of supervised entities and grounds for intervention measures. To achieve this goal, several supervisory measures should be applied according to the following supervision activities:

- Submission of prudential and financial reports (monthly, quarterly, annual, and other periodicities depending on the supervised entity);
- Additional reports (weekly, daily);
- Sector and industry research;
- Monitoring and tracking of measures taken;
- Thematic inspections;
- Comprehensive inspections;
- Stress testing results;
- Analysis of recovery plans;
- Meetings with managers of supervised entities (schedules, protocols);
- Meetings and cooperation with internal and external auditors and other structural units performing control functions of the supervised entity.

During the implementation phase of supervision, qualitative assessment is conducted for each indicator based on inspections or external supervision framework assessments, depending on the category of the supervised entity and the comprehensiveness of information obtained about the entity. This qualitative assessment evaluates the entity's management of risk elements corresponding to the indicators. The supervision guidelines reflect methodological guidance for supervisors to assess the quality of the supervised entity's management regarding these risks. The final rating of the supervised entity is considered the arithmetic mean of quantitative and qualitative assessment results (when no special weights are given to quantitative and qualitative parts - different specific weights may be determined in supervisory methodological guidelines). The final rating of each supervised entity is approved by the Supervision Committee and officially communicated to the supervised entity. After determining the final rating, the supervision intensity matrix is updated.

2.5. Determination of Supervisory Intervention Measures and Their Monitoring

The stage of determining supervisory intervention measures is a key component of risk-based supervision and aims to ensure effective elimination of identified risks in supervised entities and the financial sector as a whole. This stage defines processes and criteria for responding to risks arising from current situations and known facts in the supervised entity, considering financial stability objectives.

When determining supervisory intervention measures, taking into account the category of the supervised entity, a gradual transition from normal supervision regime to recovery and resolution phases is established, while ensuring preventive response to risks directed at the entity's sustainability and solvency. Supervision guidelines define intervention measures based on final rating and its elements. Supervisory intervention measures are applied not only based on ratings but also on results of early warning systems applied in daily supervision. Guidelines also note that these measures can be actively applied at all stages of the supervision cycle for violations and conditions that may lead to violations.

After supervisory intervention measures are applied, they are monitored by supervisors and regular reports on results are submitted to the Supervision Committee.

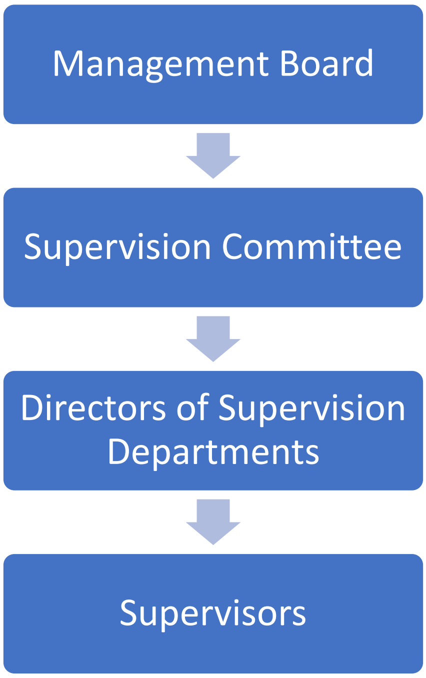
2.6. Updating Institutional Profile and Other Planning Documents

The final rating of the supervised entity, related supervisory intervention measures, and results of their monitoring are reflected in updates to the entity's institutional profile, supervision strategy, and annual supervision plan, with corresponding changes made to supervision measures. The final rating of the supervised entity also plays a key role in forming opinions and proposals during the update of supervision guidelines.

3. Organizational Structure of Risk-Based Supervision

In the ARAS supervision cycle, a top-down risk-based supervisory management structure is depicted in Diagram 3.

Diagram 3. Risk-Based Supervision Management Structure in the Central Bank



The duties and functions of these structures within the risk-based supervision framework are as follows:

Management Board: Within the risk-based supervision framework, the Management Board:

- Approves the Central Bank's supervision priorities document, which is the main document for planning risk-based supervision
- Approves the annual supervision plan
- Makes final decisions regarding reasoned judgment formed within the supervision framework in accordance with the law
- Implements final supervision and management of the risk-based supervision process
- Executes authorities defined by law within the risk-based supervision framework

Supervision Committee: The Supervision Committee consists of heads of structural units performing supervision, regulation, policy, financial stability, and resolution functions, and authorized persons of the Central Bank supervising these structural units. The Committee is chaired by an official appointed by the Chairman of the Central

Bank. Within the risk-based supervision framework, the Supervision Committee's duties are:

- Approves supervision guidelines and other internal documents related to risk-based supervision
- Reviews draft documents of the Central Bank's supervision priorities and annual supervision plans and submits them to the Management Board for approval
- Meets to discuss supervision practices and new challenges in the supervision process, reviews documents regulating the supervision process and supervision guidelines, and gives relevant tasks for improvement
- Forms reasoned judgment as provided by law, reviews the supervised entity's reasoned explanation if submitted, and brings the matter to the Management Board's discussion if the explanation is not considered justified
- Approves supervision measures (intervention measures), except for cases assigned to the Management Board's authority by law

The Supervision Committee may form temporary and permanent commissions when deemed necessary for effective performance of its functions.

Directors of Supervision Departments: Within the risk-based supervision framework, the duties of supervision department directors are:

- Approve institutional profiles of supervised entities (including their initial ratings)
- Analyze and summarize supervision strategies of supervised entities
- Submit draft "Central Bank's supervision priorities" document and Initial supervision plan to the Supervision Committee with joint agreement
- Submit opinions and proposals regarding reasoned judgment to the Supervision Committee
- Make decisions regarding the application of supervision tools during the implementation phase within the risk-based supervision framework

Supervisors: Within the risk-based supervision framework, supervisors' duties are:

- Execute supervision measures (external and internal supervision), update relevant supervision documents (institutional profile and supervision strategy)
- Provide proposals for establishing prudential requirements and taking supervision measures

Additionally, within the risk-based supervision framework, methodological and information support structural units are organized within supervision or policy and regulation departments for preparing supervision guidelines and other documents, their periodic improvement, and information support. The detailed functions of all structures mentioned above will be covered in supervision guidelines to be prepared separately for each area of the financial sector.

4. Risk-Based Supervision Implementation on the Central Bank's Other Strategic Initiatives

The implementation of the risk-based supervision approach will play a foundational role in achieving the following targets set in the Central Bank's "Financial Sector Development Strategy for 2024-2026":

I. Full Alignment of Banks' Capital Structure with Basel III Standards The final rating of the supervised entity resulting from the risk-based supervision approach will play a key role in applying the Pillar 2 buffer under Basel III Capital Standards.

II. Full Alignment of Banks' Liquidity Requirements with Basel III Standards The Liquidity Coverage Ratio (LCR) has been implemented by the Central Bank since early 2024. Results from risk-based supervision implementation will be used in assessing banks' readiness for implementing the Net Stable Funding Ratio (NSFR), another Basel III liquidity standard.

III. Implementation of Internal Capital and Internal Liquidity Adequacy Assessment Process (ICAAP/ILAAP) One of the objectives of risk-based supervision is to ensure improvement of banks' risk management, which will also ensure internal model-based capital and liquidity assessment. Simultaneously, the evaluation of these models requires development of supervisors' knowledge, skills, and judgment abilities, and the risk-based supervision process will necessitate supervisors' improvement.

IV. Enhancement of Bank Resolution Framework Within the risk-based supervision framework, the Recovery Plan itself serves as a tool for evaluating both supervision and the supervised entity's risk management. During the supervision process, supervisors monitor how supervised entities determine indicators and action plans for recovery plans, and when needed, recovery plans are improved by the supervised entity. This serves as a foundation for developing more effective resolution plans.

V. Implementation of Supervisory Technologies (SupTech) The implementation of risk-based supervision is expected to result in significant improvement in reports submitted by supervised entities, which necessitates automation in their structuring. In this direction, the implementation of risk-based supervision will be the main motivation for the SupTech project implementation, and the improvement of existing information systems and formation of new information systems within the project will ensure rapid and effective supervision process.

VI. Ensuring Compliance of Insurance Companies and Capital Market Participants' Regulation and Supervision with Solvency II and IOSCO Principles

As risk-based supervision ensures alignment with progressive international standards, it will play a key role in achieving targets for aligning insurance sector regulation with Solvency 2 standards and capital market participants' regulation and supervision with IOSCO principles.

VII. Enhancement of AML/CFT and Market Conduct Supervision The risk-based supervision approach will cover AML/CFT and market conduct supervision alongside prudential supervision of supervised entities, which will ensure advanced risk assessment and supervision in these areas.