

THE CENTRAL BANK OF THE REPUBLIC OF AZERBAIJAN

REPORT

on ACCOMPLISHMENT of MAIN GOALS and FUNCTIONS
in 2016

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INTRODUCTION

Robust financial–economic potential, resulting from the growth strategy successfully implemented over recent years under the leadership of Honorable President Ilham Aliyev allowed to minimize spillover of global economic developments to Azerbaijan in 2016 as well.

The global economic conjuncture remained unfavorable for Azerbaijan in 2016. Drop in average annual oil prices compared to the previous year and weak economic growth in main partners weighed in on indicators of the balance of payments and aggregate demand.

The Bank focused on macroeconomic stability related challenges amid decreasing foreign currency revenues.

Discharging the functions under its mandate the Central Bank rendered critical support for safeguarding macroeconomic stability in 2016.

The Bank's monetary policy was oriented towards price stability – the core indicator of macroeconomic stability meanwhile boosting confidence in the national currency. The size of money supply was regulated under the money program coordinated with related authorities, necessary corrections were made to quantitative parameters of monetary policy tools in response to macroeconomic stance and forecasts. At the same time, the Central Bank took goal-oriented efforts to improve monetary policy's strategic and operational framework.

In 2016, extending application of a flexible exchange rate announced at the end of 2015, the Central Bank created conditions for macroeconomic fundamentals based formation of the exchange rate of the national currency. To allow the exchange rate to react to supply and demand in the FX market, the Bank minimized its participation there.

In general, the monetary policy implemented by the Central Bank was critical in management of inflation.

1. ACCOMPLISHMENT OF GOALS

The goal of the CBA is to maintain price stability, organize and ensure operation of interbank centralized and other non-licensed payment systems, and support banking system stability within the authorities established by the legislation.

1.1 Maintaining price stability within the authorities established by the ‘Law of the Republic of Azerbaijan on the Central Bank of the Republic of Azerbaijan’

In 2016 the CBA took inflation target based monetary policy decisions. At the same time, the Bank took a number of efforts to improve the monetary policy’s strategic and operational framework to achieve lasting price stability in the medium run.

According to the State Statistics Committee (SSC), average annual inflation was 12.4% in 2016. The CPI components – food prices rose by 14.8% on annual average, non-food prices 16.7%, and services by 5.8%.

In 2016 overall price levels were mainly affected by swings in expense factors. The NEER, inflation expectations and swings in global commodity prices had an upward effect, while government regulation (by the Tariff Council) had various effects on prices. Whereas government regulation of pharmaceuticals and VAT exemption of wheat had downward, changes in tariffs for electricity, water and gas had an upward effect on inflation.

Average annual core inflation estimated excluding goods and services, whose prices are regulated by the government and seasonal agricultural products was 13.3% in 2016.

According to the SSC, in 2016 the PPI increased on industry and transportation, and decreased on agriculture and communication. The industrial producer price index rose 27.5%. Prices hiked by 31% in mining driven by rising oil prices, 15.2% in processing. Agricultural producer prices dropped by 2.6%, mainly driven by 9% cheapening of plant products.

As it was noted, expectations also contributed to swings in consumer prices. Inflation expectations overall heightened under certain cost factors, yet some sectors witnessed drops in expectations. CBA’s regular RSM revealed that price expectations dropped in construction materials and chemistry in industry, and in sale of furniture and home appliances in trade.

Being guided by best practices and in order to maintain lasting price stability, one of the core conditions to sustain growth, i.e. maintain low and predictable inflation, the CBA took goal-oriented efforts on providing conditions for introduction of direct inflation targeting, the monetary policy’s strategic framework in 2016.

1.2 Organization and ensuring operation of interbank centralized and other non-licensed payment systems and support for banking system stability

Stable and reliable operation of payment systems is one of the priorities for the CBA. Interbank centralized payment systems, the key components of the National Payment System (NPS), launched and managed by the CBA maintained uninterrupted operation.

Total size of payments made through the Real Time Gross Settlement System (AZIPS) and the Low Value Payments Clearing and Settlement System (LVPCSS) for small size and reiterating payments, the core components of the NPS, amounted to AZN148 B (33.2 mln. transactions). The size of payments y/y increased 8.3% (AZN11.4 B), while the number of transactions y/y increased 9% (2.8 mln. pcs).

The Bank also took actions to boost security, stability and functionalities of the NPS. International telecommunication network based AZIPS now has the capacity to conduct transactions over the Local Telecommunication Network with a standalone capacity. Functionalities of the LVPCSS were improved to include use of modern payment tools. To ensure international standards-based information security both systems were integrated to the CBA launched Bank Certificate Services Center's (BCSC) electronic signature infrastructure. The CBA's Reserve Center was further improved, now main components of the NPS operate from newly established Reserve Center 2.

Efforts to expand infrastructural capacity of the Government Payment Portal (GPP) kept going in 2016. 11 central executive power bodies, 96 courts of justice, 10 pilot municipalities, 8 legal entities whose qualifying holding belong to the state, 6 state higher educational institutions, 13 insurance companies via the Compulsory Insurance Bureau and 3 mobile communication operators were integrated to the GPP. Payments for total 430 services across these organizations, including over 400 public services (tax, duties, rent fees, administrative fines and penalties etc.) are made in cash in about 2000 payment points of the Azerpost LLC, the Nakhchivanpost LLC and 31 banks and over 700 payment terminals, and in cashless order with payment cards and bank accounts over portal's Internet resource and banks' e-banking services. The system handled total AZN2 B worth of 30.3 mln. transactions. The size of transactions handled in the system y/y increased 47.3%, while their number increased 8.4%.

Works on acceptance of payments for services supplied by public institutions at ASAN centers of the State Agency for Public Services and Social Innovations under the President of the Republic of Azerbaijan via the GPP infrastructure have been completed. The State

Agency's Internet resource and the ASAN payment system, ASAN payment terminals, mobile ASAN buses are integrated to the GPP, also payments for this coordinating authority are made in bank branches operating at ASAN Service centers and over the GPP. At the same time, internal information system of the Compulsory Insurance Bureau, the National Certificate Services Center, the 'e-court' system launched by the Judicial – Legal Counsel have been integrated to the GPP.

As part of actions implied to improve e-services on the 'National Actions Plan for 2016-2018 on Promotion of Open Government', as a result of joint efforts with the Ministry of Taxes of the Republic of Azerbaijan, to ensure centralized collection of local (municipal) taxes and payments, the Municipal Tax Information System (MTIS) used by the Ministry to automate registration of municipal tax payers has been integrated to the GPP. 10 pilot municipalities have been provided with MTIS's automated work stations allowing them to enter payer information to the central database and generate reports on received payments. Collection of local (municipal) taxes and payments via the GPP will be provided on a step-by-step basis depending on the schedule of entry of payer information across other municipalities to the MTIS database by the Ministry of Taxes. As part of other actions specified in the National Actions Plan, as a result of joint efforts with the Ministry of Education of Azerbaijan, to ensure centralized collection of tuition fees of students studying at public educational institutions, a dedicated information system has been launched at the Ministry of Education and integrated to the GPP. Information systems of state educational institutions selected by the Ministry of Education as a pilot (Azerbaijan State University of Economics, the Azerbaijan Technical University, the Azerbaijan Academy of Art, the Baku Slavic University and the Sumgait State University) have been provided with automated work stations allowing them to enter student data to the central information system and generate reports on received payments. Collection of payments from other educational institutions will be provided on a step-by-step basis depending on the schedule of entry of student information across other educational institutions to the central information system database by the Ministry of Education.

Currently, efforts are underway to further expand the GPP coverage, modernize its functionalities in light of recent IT achievements and shift to a new platform that meet today's requirements.

The card infrastructure kept developing. The number of payment cards issued in the country reached 5.3 mln. pcs, ATMs 2454 pcs, POS-terminals 71806 pcs. The size of payment card transactions y/y increased 14.4%.

To boost security of the card infrastructure the Bank completed works on launch of the Interbank Card Center (ICC) and commissioned the system on 1 March 2016. Consequently, data on transactions among service centers using issued payment cards are processed domestically. The “AzeriCard” LLC, “MilliKart” LLC, “Kapital Bank” OJSC and “YapıKredi Bank Azerbaijan” CJSC have been integrated to the ICC.

Total AZN200 M worth of 7.5 mln. pcs transactions were processed via the ICC in 2016.

Support for financial stability was one of the main priorities for the CBA in 2016 as well.

Under the Decree of the President of the Republic of Azerbaijan on ‘Establishment of the Financial Markets Supervisory Authority public legal entity’ dated 3 February 2016 the CBA’s licensing, regulation and supervision function was assigned to a new institution.

Currently, the CBA supports financial stability of the banking system mainly via its liquidity operations and as a Lender of Last Resort.

In April 2016 under the monetary program documented with the participation of and coordination by main macroeconomic regulatory authorities, money base is planned to be grown to support financial stability. Hence, according to the program, liquidity support for the International Bank of Azerbaijan (IBA) and the banking sector was the main money supply growth channel. At the same time, major part of this support was sterilized within the frames of safeguarding macroeconomic stability allowing to contain money base growth.

2. DISCHARGE OF FUNCTIONS

To attain the main goals the CBA took necessary efforts to establish and pursue the state’s monetary and exchange rate policy, organize cash circulation, regularly set and announce the exchange rate of manat against foreign currencies, regulate and control currency, develop reporting balance of payments (BoP) and participate in development of the forecast BoP, maintain and manage international gold – foreign exchange reserves at its disposal, compile consolidated (both public and non-public) foreign debt statistics and international investment balance and discharge other functions under the legislation.

2.1 Setting and implementation of the state’s monetary and exchange rate policy

Monetary policy decisions were taken to maintain price stability meanwhile boosting confidence in manat. Money supply growth was regulated in line with the monetary program coordinated with related economic policy authorities, quantitative parameters of monetary policy tools underwent critical corrections.

Minimizing participation in the FX market the CBA allowed the exchange rate of manat to react to macroeconomic fundamentals (BoP, oil prices etc.). Given the deficit in the BoP and its concentration mainly in capital and financial flow the CBA introduced a managed float regime to avoid sharp devaluation of manat, minimizing negative impact of exchange rate changes on macroeconomic and financial stability.

In light of factors contributing to inflation money base's growth channels were taken under management under the monetary program, which provides for containing growth rate of money base in manat. The CBA rested upon the monetary program in question in its liquidity operations. The main goal was to regulate money supply channels, avoid additional pressure on the exchange rate of manat, meanwhile preventing high inflation. Hence, money base became the key operational anchor of the monetary policy.

In general, the growth rate of money base was in line with the monetary program; money base in manat increased 13.9%. Money base's (previously coordinated in the monetary program) main growth channels were support for financial stability, including resources allocated to sustain banking system liquidity and payments, and returning savings of the population across closed banks.

The CBA actively sterilized excess money supply to maintain money base on a coordinated target level. The three fourth ($\frac{3}{4}$) of funds given as financial stability support were sterilized. These sterilization operations account for over 50% of money supply, consequently the Bank prevented entry of excess money supply to FX and commodity markets.

To activate sterilization operations, the CBA started deposit auctions on attraction of available funds in the national currency in June and auctions on placement of notes in November 2016. The Bank held total 26 deposit auctions on attraction of funds and 9 on placement of notes. Deposit and short-term notes placement operations both sterilize excess money supply and contribute to the money market.

To boost confidence in the national currency, and pave the way to improvement of monetary policy tools under the conjuncture in the money market, the CBA made necessary corrections to the parameters of the monetary policy tools.

The CBA Management Board decided to shift the refinancing rate to 15% from 3%, the interest rate floor to 12% from 0.1% and the ceiling to 18% from 5% in steps. Interest rate corridor related decisions based upon the macroeconomic stance and yield on government securities.

The CBA also decided to extend maturity of liquidity injections and absorptions at interest rates within the floor and the ceiling of the interest rate corridor. Banks may initiate 1 – 7-day repo/counter repo operations (tools used to place and attract funds) in an unlimited manner to manage short-term liquidity.

To stimulate de-dollarization, the CBA Management Board at the decision of 3 March 2016 moved the reserve requirement on banks' foreign currency denominated liabilities to 1% from 0.5%, decreasing liabilities to the non-resident financial sector and for settlements with international financial institutions to 0% from 0.5%. The reserve requirements were introduced on an averaging basis, which had an upward effect on the development of the interbank market and more flexible management of liquidity by banks.

The Bank continued efforts on development of the monetary policy's institutional grounds. Researches were conducted on the directions under the Bank's mandate and functions, existing econometric models were further purified. The CBA kept on focusing on development of statistics, and regularly estimated the business confidence index on the basis of the real sector monitoring. Quarterly Monetary Policy Review was released as part of the effective communication of the monetary and exchange rate policy to shape adequate expectations in economic agents, and relevant monetary policy decisions and their substantiation were promptly made public.

2.2. Organization of cash circulation, issue of monetary units to and withdrawal from circulation under Part II, Article 19 of the Constitution of the Republic of Azerbaijan and the 'Law of the Republic of Azerbaijan on the Central Bank of the Republic of Azerbaijan'

In 2016 demand of the economy for cash was covered in full, under the required structure and in time.

The CBA withdrew AZN8.8 B worth of (353.1 mln. pcs) monetary units from and issued AZN10.3 B worth (19.7 mln. pcs) of monetary units into circulation. In general, money in circulation increased AZN 1.5 B (28.6%) to AZN6.9 B as of the end-year.

The 'Clean money in circulation' policy adopted to make the quality of money in circulation higher kept going. Currency returned to cash centers of the CBA from circulation was handled, currency unfit for circulation was taken out of circulation. AZN10 M worth of currency unfit for circulation was replaced by the 'Public service offices' created at the CBA.

Moreover, to organize more tense circulation of coins the 'Mobile cash office' created at the CBA continued functioning, AZN636.5 thousand (2.3 mln. pcs) was issued to circulation.

The CBA attached great importance to effective anti-counterfeiting, counterfeit currency detected in circulation was delivered to law-enforcement bodies for relevant investigations. As of the end-period the number of counterfeit banknotes per 310000 pcs of banknotes was 1, considerably low compared to relevant indicators of other countries (the rate in the euro zone 1 fake currency per 30000 pcs of banknotes).

The CBA continued efforts with respect to the framework on issue of commemorative coins to circulation. The Bank issued into circulation gold and silver commemorative coins dedicated to the 20-year anniversary of the 'Contract of the Century', 'Azerspace' telecommunication satellite, TANAP the national gas pipeline and Baku-Tiflis-Kars railway.

The Bank focused on development of regional central banking. International standardization of regional centers and their optimization by means of management systems unification completed, their functional frames were reviewed after the recent amendments to the Law of the Republic of Azerbaijan on the Central Bank of the Republic of Azerbaijan.

The CBA also took necessary efforts to manage cash on the basis of progressive practice, optimize the treasury infrastructure and align it to international standards, maintain security in cash related business processes, minimize risks and improve relevant internal control procedures. The Bank finalized the projects implied within the frame of the 'Formation of cash management's most modern standards', including launch of the integrated Cash Management System (CMS), creation of a new logistic model for cash management, and creation of business processes based upon international standards on money expertise.

2.3 Regular setting and announcement of the official exchange rate of manat against foreign currencies

In 2016 the exchange rate of manat was in line with BoP trends and within the managed float frame announced by the CBA at the end of 2015.

The CBA introduced an operational framework under the new exchange rate regime it had announced, minimized its participation in the FX market; the State Oil Fund of the Republic of Azerbaijan (SOFAZ) sold currency at CBA initiated auctions. Currency auctions were conducted once a week, and participants were informed about the parameters of each auction via the Bloomberg platform prior to the auction. Over the year the SOFAZ sold \$4.9 B worth of currency (y/y down 37.5%).

The Bank conducted total 114 currency auctions in 2016. Auction parameters were flexibly adjusted to the FX market, and auction mechanisms were improved. To allow banks to more flexibly get involved to the FX market, the CBA introduced a new double auction mechanism in October which allows market participants to place orders in both directions (both buy and sell).

The Interbank FX Market also operated on a regular basis on non-auction days. The size of Interbank FX Market's off-auction buy and sale transactions tended to rise over the period

The new exchange rate regime allowed the CBA to maintain reserves. As of end-2016 CBA's foreign exchange reserves exceeded internationally set sufficiency rates (coverage of three-month import of goods and services, ratio to money supply in the national currency etc.).

Over the period the official exchange rate of manat was equal to the average exchange rate on interbank transactions (including auction and off-auction transactions). The CBA has been announcing an official exchange rate for the following business day one business day before since the beginning of 2016.

Manat reacted to supply and demand in the FX market with several waves of appreciation and depreciation. Whereas as of end-2015 the USD/AZN exchange rate was AZN 1.5594, it peaked to AZN 1.6456 on 11.03.16, and plunged to AZN 1.4900 on 25.05.16. The USD appreciated in June–August, depreciated in September, and was prone to appreciating from End-October. The USD has appreciated 13.6% against manat since early 2016. Average daily USD/AZN exchange rate was 1.5965.

The behavior of bilateral exchange rates influenced that of multilateral exchange rates. Total trade weighted REER of manat on the non-oil sector depreciated 19.8%, driven by 27.5% depreciation of the NEER. Depreciated REER supports import substitution and stimulates exports.

2.4 Maintaining currency regulation and control under the 'Law of the Republic of Azerbaijan on Currency Regulation'

The CBA regulated and controlled currency according to the Law of the Republic of Azerbaijan on Currency Regulation and related regulations developed on its basis.

Currency regulation and control was maintained in line with the trends in the FX market, with a number of initiatives taken to decrease pressures on the exchange rate of manat.

To exercise more control over the cash FX market, banks' currency exchange offices were liquidated, and requirements on identification of foreign currency sales were toughened.

A new edition of the 'Regulations on bringing foreign currency into and taking out of the Republic of Azerbaijan by residents and non-residents' was released at resolution of the CBA dated 3 March 2016.

To support rebalancing of the BoP the currency control regime underwent changes. A new edition of the 'Regulations on currency operations of residents and non-residents in the Republic of Azerbaijan' was released at the decision of the CBA dated 28 November 2016 to boost financial discipline of currency operations of individuals and legal entities functioning in the country, and make import-export operations more transparent. According to the Regulations, in exchange for import related advance payments goods should be imported or services should be supplied within 180 days and accompanying documents should be submitted to the bank. Moreover, limits have been imposed on currency transfers from the country through individuals' bank accounts and without opening accounts (to close relatives up to \$10 000, in other cases \$1000 over operation day, total \$10 000 a month). Operation limits are also set on transfers to close relatives.

Under the related decree of the President of the Republic of Azerbaijan, although segregation of authorities between the CBA and the FMSA is determined under the amendments made to the Law of the Republic of Azerbaijan on Currency Regulation dated 4 March 2016 due to establishment of the FMSA, authorities need to be clarified. Draft related amendments have been submitted to the Government.

2.5 Storage and management of international gold-foreign exchange reserves at its disposal

Amid low yield and high volatility in 2016 the key policy of the CBA's foreign exchange reserve management policy was maintenance of reserves.

In 2016 global economic growth was lower than expected. The US Fed raised the key rate to the range of 0,50 – 0,75%, while the euro zone continued quantitative easing to stimulate the economy. After the result of the Brexit referendum the Bank of England started a monetary stimulation policy.

Given both drop in foreign exchange reserves and tailoring of the investment activity to a new economic – financial environment, liquidity and high lending quality of assets was maintained in foreign exchange reserve management. As of the end-period official foreign

exchange reserves were held with reliable financial institutions – 87% in the USD, 7% in the euro, 3% in the pound, and 3% in SDR.

CBA's foreign exchange reserves amounted to \$4 B as of the end-period. The Bank earned \$24,17 M worth of income from currency asset management.

2.6 Development of the reporting and participation in development of the forecast balance of payments under the legislation

Compiling of the international standards based BoP continued in 2016, actual and forecast indicators of the BoP were one of the critical information sources for adequate decisions in the macroeconomic policy.

Given recent trends the CBA developed and regularly updated the forecast BoP, regularly consulted with related authorities with respect to forecasting of the BoP, and sent necessary inquiries to a number of large state owned enterprises. At the same time, the Financial Stability Board discussed BoP's forecast indicators and their effect on the FX market.

To improve BoP compiling at the CBA, under the IMF Balance of Payments Manual (6th edition), new changes to the 'Regulations on compilation and submission of reports on financial operations of residents of the Republic of Azerbaijan with non-residents' were approved. Under these changes, the Bank installed software of a new reporting system on introduction of the closed International Transactions Reporting System (ITRS), whose automation has been completed. The new ITRS will allow to generate detailed information on legal entities engaged in over \$200 thousand worth of foreign currency operations, which, in its turn, is critical in further improvement of the BoP reporting, accounting and forecasting.

Starting from Quarter II, 2016 initially reporting has been tested across systemically important banks as a pilot project and the new reporting form started to be applied. It is very important in terms of further purification of the BOP's reporting and accounting system, deepening of analytics in terms of foreign exchange balance, and harmony among indicators.

2.7 Develop country's consolidated (both public and non-public) foreign debt statistics and international investment balance, summary and dissemination of data

The Bank continued efforts on collection and summary of data for consolidated foreign debt statistics and international investment balance.

To ensure implementation of and resolve related issues from Resolution # 118 of the Cabinet of Ministers 'on improvement of mechanisms for organization, consolidation and

dissemination of international standards based foreign debt and international investments statistics' dated 22 April 2015, related technical works have been done on the level of the task group initiated by the CBA represented by related public authorities as well.

Within the frames of the IMF technical mission the Statistics Department developed a report on compiling foreign debt statistics and international investment balance and held meetings with related economic authorities, banks and international oil-and-gas consortiums to obtain data.

Currently, statistic data are collected from various sources for compiling foreign debt statistics and international investment balance. The Bank receives quarterly data on current accounts, deposits, gold assets of the SOFAZ, its investments to securities, derivatives and real estate. The Ministry of Finance submits quarterly data on government and government guaranteed public debts. The SOCAR and the Southern Gas Corridor submits quarterly data on foreign debt and international investments. At the same time, the Bank obtains monthly data on attraction and payment of foreign debts by state owned enterprises.

Reporting forms on foreign borrowing have been clarified over the reported period, the State Statistics Committee delivered initial data on Quarter III, 2016.

Efforts are under way on development of an initial pilot version of the country's aggregate debt statistics on results of 2016.

2.8 Discharge of other functions provided for in the 'Law of the Republic of Azerbaijan on the Central Bank of the Republic of Azerbaijan' and other laws

The CBA also operated on implementation of the functions arising from the Law of the Republic of Azerbaijan on Deposit Insurance.

Being represented in the Trustee Board of the Deposit Insurance Fund (ADIF) the CBA rendered its support on improvement of the deposit insurance system.

At the CBA initiative the Trustee Board of the ADIF set 3% in a foreign currency and 12% in the national currency for annual interest rates of protected deposits from 2 March 2016 onward to mitigate bank risks and dollarization. Later the maximum interest rate for protected deposits in manat was raised up to 15%.

At the same time, at the proposal of the CBA the Law on Full Deposit Insurance was adopted on 19.01.2016 and currently irrespective the amount deposits placed within the

frames of interest rates set at the decision of the Trustee Board of the ADIF are insured in full amount for 3 (three) years.

The CBA issued government backed loan to the ADIF for support of the banking system stability as part of bank's restructuring and rehabilitation to cover the missing part of compensations to pay to depositors of liquidated banks according to the amendments made to the Law of the Republic of Azerbaijan on Deposit Insurance.