THE CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

2011 ANNUAL REPORT

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FOREWORD

In 2011, Azerbaijan economy saw a continued development process, while macroeconomic stability was maintained in a complex global economic environment. Strategic foreign exchange reserves of the country continued to accumulate in light of surplus in the balance of payments.

In line with its announced key directions of monetary and financial stability policies, in 2011, Central Bank has focused on realization of such targets as maintaining single-digit inflation, ensuring stability of manat exchange rate, and strengthening development and sustainability of banking/financial sector. Central Bank achieved a single-digit inflation target by pursuing an anti-inflationary monetary policy throughout the year. In the meantime, the stability of manat exchange rate was preserved in the backdrop of expanding supply of foreign exchange.

In 2011, Central Bank continued measures aimed at minimizing risks in the banking system, ensuring stable functioning of banks, strengthening management capacity, repairing assets, increasing the level of financial provisioning, and preserving confidence in banks. Development of risk-based prudential supervision framework was fostered incorporating on-going Basel III standards on potential risks and bank supervision, while oversight regime and tools were introduced that were necessary to ensure a more reserved and sound activity of banks under new macroeconomic settings . As a result of these measures, continued financial stability of banking system was maintained, key sector indicators continued to increase, bank assets quality was kept at acceptable range, and liquidity of banks remained high.

To improve the access of market agents to financial resources, the expansion of regional network of banking/financial sector was continued. Along the banks, non-bank credit institutions expanded their scope of activities and coverage as well.

On-going mortgage lending in the country contributed to support economic activity while improving housing conditions of population. As in previous years, a practice to mobilize market resources for mortgage lending was kept on in 2011 as well.

Continuous and reliable use of payment systems was well maintained in 2011. The integration of retail payment infrastructure elements expedited. Economic agents, including households saw increased opportunities to settle payments over the bulk clearing system. Meanwhile, measures were kept on to promote a wider scope of use of non-cash payment tools.

Throughout the year, as one of its traditional functions, Central Bank ensured organization of cash circulation, issue and withdrawal of bank notes, met the national economy's demand for cash in a full and timely manner, and maintained strategic cash reserves.

Given the complicated global environment in 2011, the overarching priority of Central Bank's policy in managing foreign exchange reserves was to maintain security of its holdings. Currency diversification and high credit quality of assets were identified as key components of investment policy on foreign exchange management with reserves invested in primarily reputable financial institutions.

Throughout the year, Central Bank continued its efforts to enhance capacity in anti-money laundering and combating financing of terrorism, and to develop internal control system in the particular area of engagement. As a result of these measures, the Financial Monitoring Service at the Central Bank was granted a full membership of the club of international financial intelligence units, the Egmont Group. This membership represents a significant achievement in terms of strengthening Azerbaijan's position in the given field.

Central Bank continued to engage actively in developing international relations and strengthened its cooperation with international financial organizations and foreign central banks in 2011. “Azerbaijan Days” was held on March 15-16, 2011, at the World Bank's Headquarters in Washington, D.C., USA, organized jointly by Central Bank and the World Bank's Country Office in Azerbaijan.

To respond effectively to new challenges emerging in changing and increasingly complex global environment, to foster its own institutional development, and to bring its strategic management system up to leading international practice, a Strategic Plan for 2011-2014 was developed by Central Bank. A new institutional framework was set up for successful implementation of the Strategic Plan in a gradual manner through various programs and projects.

Hence, Central Bank succeeded in implementing its objectives and functions mandated by legislation in 2011. The Bank was able to reach all targets set forth, kept in check negative impact of all factors on macroeconomic stability in a preventive manner, managed inflation within single-digits, maintained stability of the exchange rate of manat, and enabled financial sustainability and stable development of the banking system. Furthermore, Central Bank provided for effective and reliable functioning of the payment systems, ensured meeting of the economy's demand for cash, and efficiently managed its foreign exchange reserves.

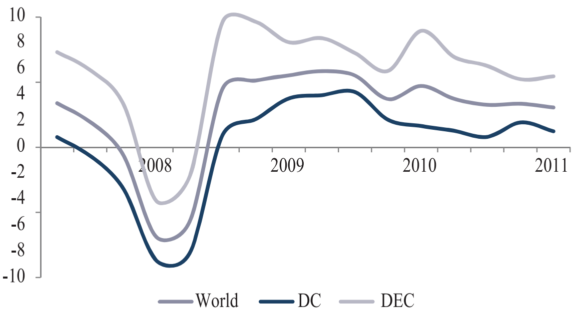
Elman Rustamov
Chairman of the
Central Bank of Azerbaijan

I. GLOBAL ECONOMIC PROCESSES IN 2011

While the global economy did demonstrate growth in 2011, its pace was somewhat diminished mainly by the increasingly deteriorating debt issues of the world's leading countries. The unemployment reduction policy and the fiscal consolidation programs implemented in the developed countries (DC) drifted further apart, while the declining financial sustainability of financial intermediation and businesses has adversely affected the private demand.

Although the economic growth rate early in 2011 exceeded the expectations, trends of decline were registered starting from the 2nd quarter, which, gaining speed and scope, enhanced considerably in the 4th quarter of the year.

Chart 1. Quarterly growth rate of global economy, %



Source: IMF

DC's displayed a greater decrease of the economic growth rates during the year. As per the International Monetary Fund's (IMF) estimates, the economic growth rate in 2011 halved in the DC's, while dropping down by 0.9 percentage points against the previous year in developing countries (DEC).

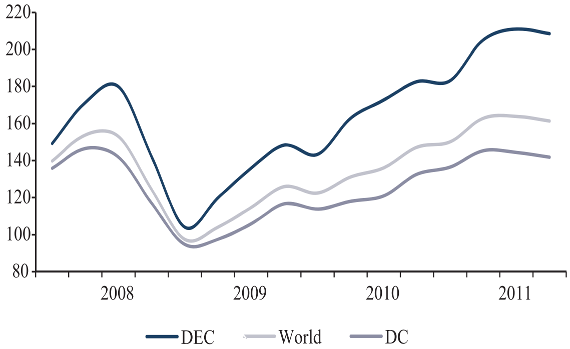
Increasingly deteriorating debt issues appeared to be the primary contributor to the slowdown of the global economic growth rate in 2011. McKinsey Corporation assessed the debt statistics of 15 countries accounting for ¾ of the world economy (G7 countries, Greece, Spain, Portugal, South Korea, China, India, Russia and Brazil), and determined that the gross sovereign and private debt of these countries totaled USD136 trillion, thus exceeding the GDP by 3 times. The USA's share amounted to 31% or USD42 trillion of the grand total. Japan was assessed as the largest debtor in the public sector, England in the financial sector, Spain in the real sector, and France in the household sector. The overall public debt reached as high as 88% of the GDP in Euro zone, 102% in USA, and 233% in Japan.

The decline of economic growth rates in DEC's in 2011 against the previous year's levels was driven primarily by deteriorations in external environment and domestic demand. Preliminary assessments estimate China and India's growth rates as the highest among DEC's.

As the public debt of DC's reached the GDP level, and the public sector of DEC's had a large-scale collection rate, the global disbalance further deepened. Global balancing requires for the DC's public demand to be partially replaced with private demand, while DEC's need to replace external demand with domestic demand. However, global balance cannot be accomplished due to the following reasons: high maintenance costs of DC infrastructure, high unemployment rate, weakening of private sector agents caused by the crisis, etc. In addition to the debt problems, the decline in bank financing in DC's during the reported year also reduced the economic growth rate.

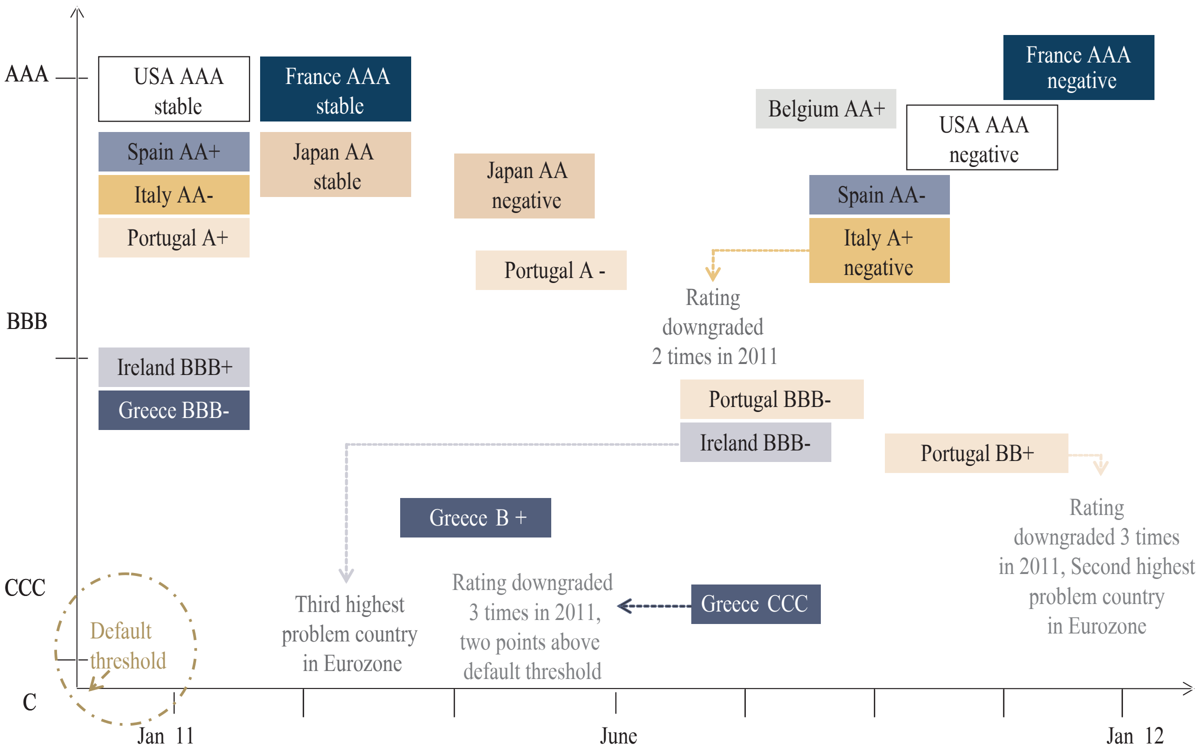
Although the annual growth rate of the **world trade** amounted to 5% as compared to 2010, the trend

Chart 2. World trade



Source: IMF

Chart 3. Changes in sovereign ratings



Source: Fitch Ratings

reversed from mid-year on. In an environment of a global financial crisis, the world trade declined to a greater extent as compared to the gross issuance due to a number of specific factors such as strong vertical connections, financial constraints and structure of exports; whereas, the latest assessments indicate that the decline in world trade has rather been driven by the overall global environment and not the specific factors

According to UNCTAD, DEC's surpassed DC's in terms of foreign direct **investments** (FDI) for the first time in 2011, with Latin American and Caribbean countries taking the lead among DEC's respecting FDI.

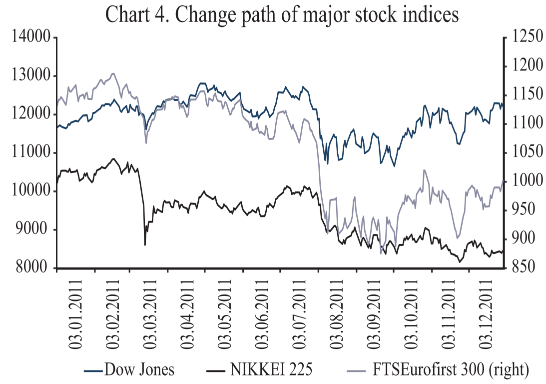
The continued high level of unemployment remained one of the major issues faced by the global economy in 2011. DC unemployment rate was 8.6%, which is 2.8 percentage points higher than the pre-crisis period's level (compared to 2007). According to the International Labor Organization's (ILO) estimates, 27 million people have lost their jobs since the onset of the crisis, thus increasing the total number of the unemployed to 200 million people.

According to the ILO's estimates, an additional 400 million jobs is required in order to preclude the growth of global unemployment in the next decade. A sustainable solution to the unemployment problem would include improvement of qualification of young labor force and ensuring that training and education are capable of addressing the contemporary challenges.

Risks on global **financial markets** have increased dramatically. Risk premiums have risen on long-term government securities in some European countries, while countries with high sovereign debts, such as USA, Japan and Germany, experienced a decline of risk premiums.

Uncertainties ensuing from the European debt problems and the subsequent downgrade of sovereign ratings were the primary reason behind the increasing volatility of financial markets in both developed and

Chart 4. Change path of major stock indices

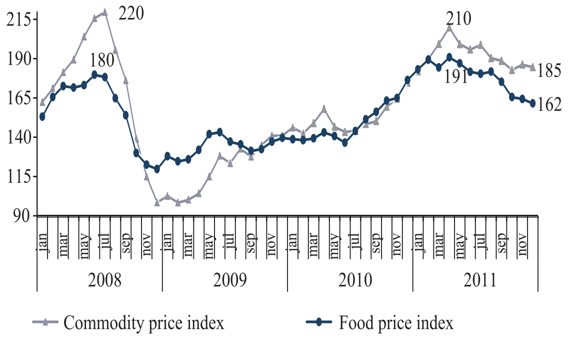


Source: Financial Times

developing countries set off in early 2011. Italy's rating was reduced 2 times, and Portugal's rating was reduced 3 times during the year. Greece experienced the worst-case scenario: its rating was downgraded 3 times, thus dropping to a level, which exceeds the default threshold by as little as 2 points only.

The rating downgrade also affected banks and real sector agents in addition to the countries. A rating cutdown of approximately 100 banks out of the 300 largest European banks in the latter half of 2011 has considerably reduced the access of private sector to finance. In this environment, DEC risk premiums rose, while capital flows and exchange rates experienced greater fluctuations.

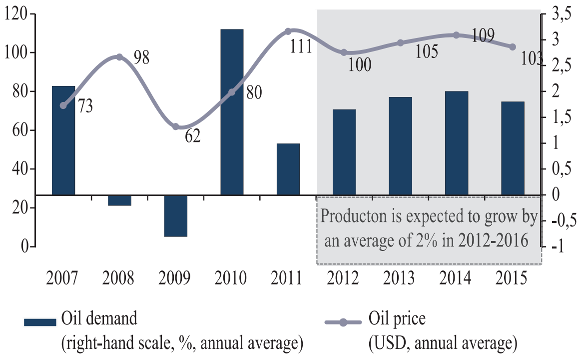
Chart 5. Global price indices, %



Source: IMF

Following an increasing string for two consecutive years **commodity prices** peaked in April 2011. However, subsequent growth of agricultural production, deteriorating global macroeconomic expectations from the second quarter and declining demand in DEC's have caused the prices to go down. Metal prices went down by 23%, agricultural products by 25%, while food prices that had hit their record level dropped down by 15%. Cotton and rubber prices nearly halved, crop prices decreased by 18%.

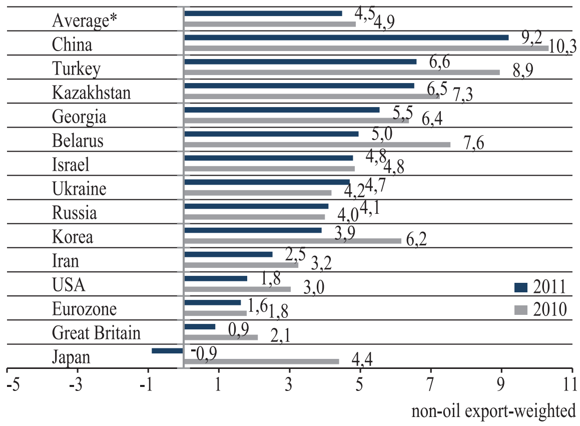
Chart 6. Global demand for oil and oil prices



Source: Economic Intelligence Unit, IMF

Brent oil averaged at USD 111 in 2011. Oil prices remained high due to the persistingly high political risks. On the other hand, demand for oil increased by approximately 1% in 2011 against the previous year's level, thus totaling to 89 million barrels per day.

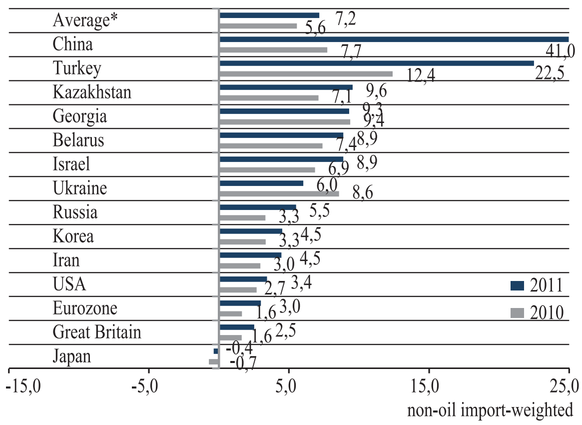
Chart 7. Economic growth rate in trade partner countries in 2010-2011 (%)



Source: International Monetary Fund and ASSC

In 2011 **major trade partners of Azerbaijan** experienced a 0.4% decline of average economic growth rate, and a 1.6% increase of average inflation rate against the 2010 levels. Only Russia and Ukraine demonstrated a higher-rate growth.

Chart 8. Inflation rate in trade partner countries in 2010-2011, %



Source: International Monetary Fund and ASSC

The currency crisis in Belarus boosted the country's inflation rate. Iran also experienced an inflationary rise and found its national currency hard-pressed for depreciation.

Early in 2011 some central banks felt they had to employ a more stringent approach to **monetary**

Box 1. Effect of oil prices on economic growth

World Bank experts simulated the effects of a probable USD50 increase of oil prices for a period of one year starting from the latter half of 2011 on the global real economic growth. The exercise indicated that the USD50 increase of oil prices would have a reducing effect on global economic growth at the rate of 0.5% in 2011, and 1% and 0.4% respectively in the next two years. It should be noted that while oil exporting countries would certainly benefit from oil price increase in terms of economic growth, oil importing countries would experience the exact opposite.

Oil exporting countries of Sub-Saharan Africa are expected to benefit the most from the above indicated oil price increase (6.6% real economic growth in 2012), while oil importing countries of Middle East and North Africa would incur the most adverse effects thereof (-2.3% in 2012).

	Real GDP change, %			
	2010	2011	2012	2013
World	0.0	-0.5	-1.0	-0.4
Oil exporting countries	0.0	0.2	0.5	0.9
Oil importing countries	0.0	-0.6	-1.3	-0.7
Developed countries	0.0	-0.6	-1.2	-0.6
Oil exporting countries	0.0	-0.4	-0.6	0.3
Oil importing countries	0.0	-0.6	-1.2	-0.7
Developing countries	0.0	-0.1	-0.4	0.0
Oil exporting countries	0.0	0.9	1.6	1.5
Oil importing countries	0.0	-0.7	-1.5	-0.8
Middle income countries	0.0	-0.1	-0.4	0.0
Europe and Central Asia	0.0	-0.2	-0.2	0.8
Oil exporting countries	0.0	0.1	0.7	2.0
Oil importing countries	0.0	-0.5	-1.2	-0.6
Middle East and North Africa	0.0	0.8	1.3	1.1
Oil exporting countries	0.0	1.5	2.4	1.4
Oil importing countries	0.0	-1.4	-2.3	0.0
Sub-Saharan Africa	0.0	1.0	1.7	1.4
Oil exporting countries	0.0	3.7	6.6	4.4
Oil importing countries	0.0	-0.9	-1.6	-0.7

Source: World Bank, "Global Economic Prospects", June 2011 report and CBA estimates.

policy given the risk of economic overheat. However, as default risks, economic recession and inflationary pressures subsided in the latter half of the year, most countries switched to less abrasive or even neutral monetary policies. Finding themselves in a dire situation, some central banks even resorted to extraordinary solutions. For instance, the European Central Bank launched a longer-term (3 years) refinancing credit program and expanded the loan security list in December.

Overall, fiscal impulses had a greater effect on global economic developments than monetary policy in 2011. Both policies tended to give rather stringent signals during the year.

In 2011, some countries (Russia, Germany, France, Britain, Mexico) pursued a policy of considerable fiscal consolidation, while others (USA, Canada, China, SAR, etc.) followed a more moderate path. Countries of considerable and moderate fiscal consolidation reduced their budget deficit/GDP ratio by an average of 2% and 0.5% respectively in 2011.

Despite the fiscal consolidation measures, public demand still represents the major contributor to economic growth in DC, except USA.

Given the processes taking place at the global scale, the IMF downgraded its **economic growth forecast** on almost all major countries (except USA). The Fund expects global economic activity to pick up in 2013 after a certain slackening in 2012.

Table 1. Major fiscal policy trends in 2011, budget deficit/GDP, %

Fiscal aim in 2011	Countries	2010	2011	Change (%)
Considerable fiscal consolidation	Russia	-3.5	0.5	4
	Germany	-4.3	-1.1	3.2
	France	-7.1	-5.7	1.4
	Spain	-9.3	-8	1.3
	Great Britain	-9.9	-8.6	1.3
	Mexico	-4.3	-3	1.3
Moderate fiscal consolidation	USA	-11	-9.5	1
	Canada	-5.6	-4.9	0.7
	Italy	-4.5	-3.9	0.6
	India	-8.9	-8.5	0.4
	China	-2.3	-2	0.3
	Brazil	-2.8	-2.6	0.2
	SAR	-5.1	-4.9	0.2
Fiscal expansion	Japan	-9.3	-10	-0.8

Source: IMF, 'Fiscal Monitor' Report

The global recession that had originally set out from Europe is estimated as the primary risk for 2012. At the same time, employment, sovereign debt and unsustained finance in leading countries are put as the most significant risks that the global economy will be facing in 2012-2013.

Table 2. IMF's forecasts (projections)

	2011(g)	2012(p)	2013(p)
Economic growth rate, c.p.y, %			
World	3.8	3.3 ↓	3.9 ↓
DC	1.6	1.2 ↓	1.9 ↓
USA	1.8	1.8	2.2 ↓
Eurozone	1.6	-0.5 ↓	0.8 ↓
DEC	6.2	5.4 ↓	5.9 ↓
China	9.2	8.2 ↓	8.8 ↓
CIS	4.5	3.7 ↓	3.8 ↓
Exports, c.p.y., %			
DC	5.5	2.4 ↓	4.7 ↓
DEC	9.0	6.1 ↓	7.0 ↓
Consumer prices, c.p.y., %			
DC	2.7	1.6 ↓	1.3 ↓
DEC	7.2	6.2 ↑	5.5 ↑

Source: IMF

Box 2. Evaluations by Fitch Ratings

Fitch Ratings assesses country ratings regularly using its well-developed trademark methodology. Ratings are designed to address future performance based on evaluations of the current situation, potential difficulties and opportunities. Country ratings are composed on a number of factors ranging from current risks to probable default estimates. Each country's rating is universally deemed to play a key role in determining future economic activity, investments and financial stability.

Rating	Description of rating
AAA	Highest rating. The country has a minimum default risk.
AA	A very low probability of default.
A	Despite the very low probability of default, some changes in economic conditions might impact the country's performance in terms of payments and financial obligations, as opposed to highest rated countries.
BBB	Certain default risks exist. Changes in economic conditions may have an impact on the country's performance in terms of payments and financial obligations, as opposed to highest rated countries.
BB	Default risk is greater because of the one-level lower rating. Changes in economic conditions may drive fluctuations in the country's ability to perform in terms of payments and financial obligations.
B	Higher default risk.
CCC	Default risk is realizable. The country's ability to perform in terms of payments and financial obligations is directly dependent on economic conditions.
CC	The country's already displays some signs of default.
C	Default is inevitable.
D	The country is already in default.

Source: Fitch Ratings

According to the IMF, a focus should be placed on three priority groups of policy challenges in order to prevent the above described risks from arising, namely coordination of the macroeconomic policy, improvement of the fiscal policy's design, and a clear delineation between the macroprudential and the monetary policies.

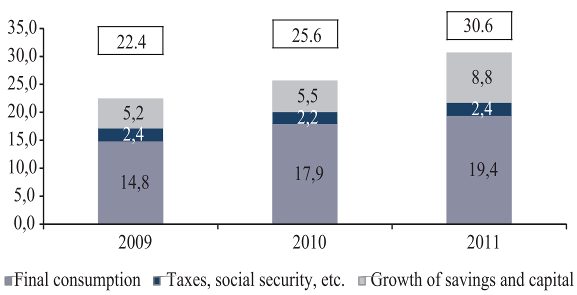
II. ECONOMIC GROWTH IN AZERBAIJAN AND ITS SOURCES

2.1. Aggregate demand

All components of aggregate demand, including final consumption expenses, investments and external demand had a positive effect on economic growth in 2011. Increased household income and domestic investments, alongside the favorable foreign position contributed to the vitalization of the GDP's demand components.

Final consumption expenses represented the chief factor of the economic growth in 2011. Household consumption continued to grow. Nominal cash income per capita increased by 18.1% against the previous year's level, thus reaching AZN3384.

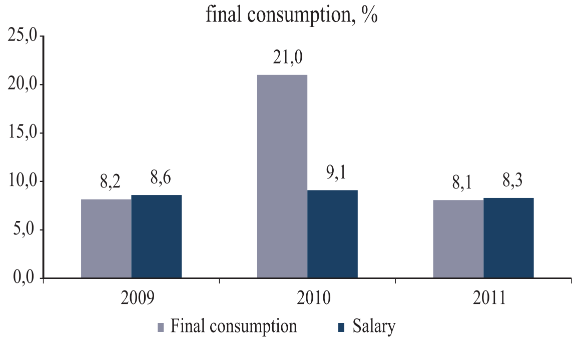
Chart 9. Household income, AZN billion



Source: State Statistics Committee (SSC)

Real household income increased by 11.7%, with 63.3% of the total income spent on final consumption of goods and services. Final consumption expenses of households increased by 8.1% in nominal terms against the previous year, totaling AZN19.4 billion or 38.7% of GDP.

Chart 10. Average monthly salary and changes in household final consumption, %



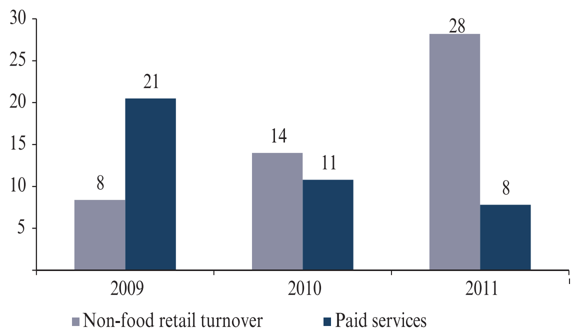
Source: SSC

Average monthly salary increased by 8.3% to AZN356.6, which also helped maintain a high share of final consumption in GDP.

Salary income of employees on payroll accounted for approximately 1/5 of the total household income. In parallel, a 22% increase in lending, including loans to households, as well as an increased influx of foreign bank notes also had a stimulating effect on demand.

The continuing growth of demand contributed to the increase of retail turnover and paid services.

Chart 11. Change path of commodity turnover, %



Source: SSC

Retail turnover increased by 10.2% during the year, wherein non-food retail went up by 28.2%. Paid services increased by 7.8%. Industrial and trade reserves were diminished as the economic activity expanded.

As was the case in the previous years, **public demand** played a key role in enhancing the aggregate demand in 2011. Preliminary estimates suggest that budget receipts from all sources totaled AZN15.7 billion, while expenditures amounted to AZN15.4 billion. Thus, the budget surplus amounted to AZN306 million (0.6% of GDP).

Government's consumption expenses formed primarily from the state budget's spending on goods and services. 30.6% of the budget expenditures covered salaries, pensions and allowances.

Capitalization of the economy carried on in 2011, financed primarily from the domestic funding sources.

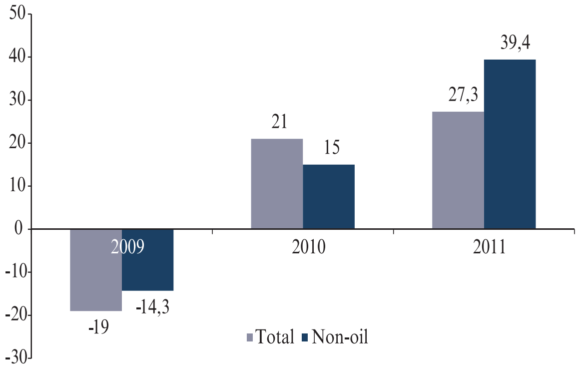
Box 3. Fiscal ratio index

One ratio may not be sufficient to evaluate the fiscal sustainability of a specific country, especially a DC. Therefore, IMF experts offer a fiscal ratio index combining 12 individual ratios. These include the gap between the interest on borrowings and the economic growth rate, cyclically cleaned budgetary balance, total debt burden, maturity structure of debts, public debt in foreign exchange, pension and health care commitments of the state budget, etc. The price area of the index is in 0-1 range; price close to 1 indicates a deterioration of the fiscal situation.

Index calculation identifies that DC's main fiscal sustainability issues stem from the total public debt and overall financing needs, while DEC's are experiencing problems related to the cyclically cleaned budgetary balance (pro-cyclic fiscal policy). The 30% public debt increase in DC's in relation to the GDP as compared to the pre-crisis period provides clear evidence of their critical situation. The Fund's simulation demonstrates that in order to bring the debt burden back to a manageable level by 2020, DC's would require a budget surplus at 7.8%, and DEC's at 2.8% of the GDP.

Source: "Fiscal Monitor", IMF, September 2011

Chart 12. Change path of investments in the economy, %



Source: SSC

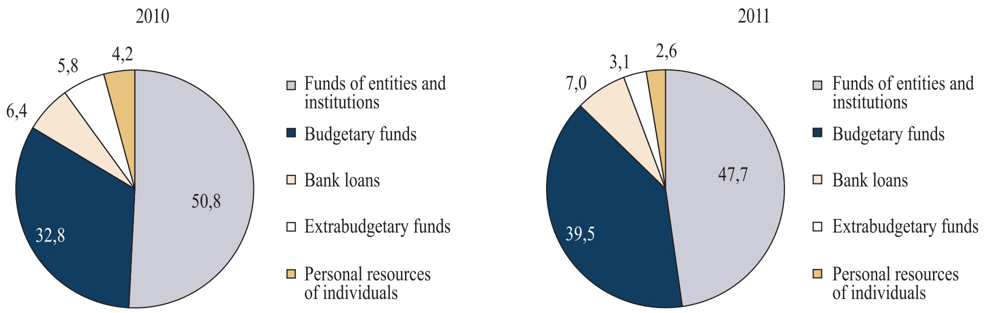
SSC reports investments in the economy from all sources fixed capital to have increased by 27.3%, thus amounting to AZN12.8 billion, which makes 25.5% of the GDP. Domestic investments increased by 35%, while foreign investments by 3.2%.

In 2011, 76.8% of the total investments were directed to the non-oil sector. In general, investments in the non-oil sector exceed the last year's level by 39.4%. Construction, machinery and equipment production, chemical and agricultural sectors account for the largest share of investment growth among non-oil sectors.

47.7% of the investments were financed by the entities' and institutions' own funds, 7% from bank loans, 39.5% from budget funds, 3.1% from extrabudgetary funds' resources and 2.6% from personal resources of individuals. Investment-purpose bank loans increased by 37.5% against the previous year.

A survey of processing industry enterprises carried out by the Central Bank also indicates a high level of investment activity. Survey findings demonstrate that over a half of investment expenditures were directed to machinery and equipment. As a priority 40% of respondents stated production upgrade, 34% expansion of production and 20% release of new

Chart 13. Investments by sources



Source: SSC

products. As a source of investments 45% of respondents stated bank loans, 28% profits and 17% amortization charges.

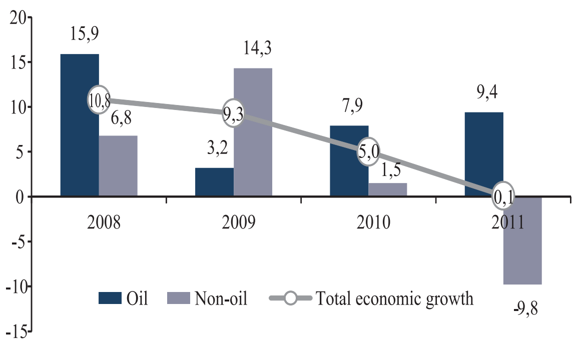
2.2. Aggregate supply

Economic growth continued in 2011 as aggregate demand expanded, with the non-oil sector's economic activity rising in particular. Increased exports and restoration of external funding sources had a positive effect on the domestic economic growth.

The real growth rate of the GDP was 0.1% in 2011, with the nominal GDP reaching AZN50.1 billion. Both real growth rate and GDP deflator (17.8%) had an increasing effect on the nominal GDP. Despite the 9.8% real decline in the oil and gas sector, the sector's nominal GDP increased by AZN4.9 billion. The oil and gas sector's real growth rate made 9.4%.

Production sectors accounted for 68% and services sectors for 32% of the added value generated. GDP per capita rose by over 20% amounting to AZN5531 or USD7003[1].

Chart 14. Economic growth rate, %



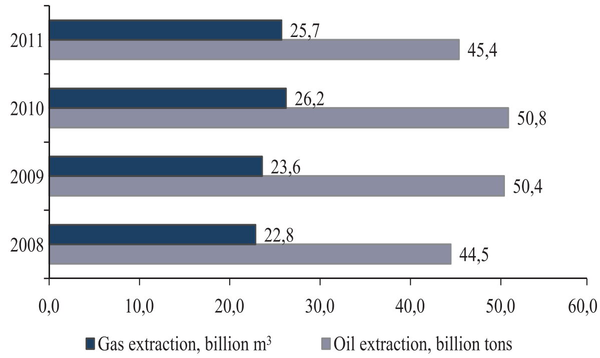
Source: SSC

The GDP growth covered virtually all sectors of economy. Non-oil industries accounted for 50% of the GDP produced in the country; the non-oil sector accounted for 4.2% of the overall growth.

In general, the last decade's continuous economic growth has enabled Azerbaijan to raise its worldwide ranking in terms of income levels. As a result, the IMF reported the country's 2011 year-end GDP per capita at USD10 thousand based on the Purchasing Power Parity (PPP) rate. Economic growth manifested itself in the social conditions as well. In the past ten years poverty was reduced by roughly 6 times, going down to 7.6%.

The GDP growth in 2011 was driven primarily by the **tradable sectors**[2]. Crude oil production decreased by 10.5%, natural gas production by 2.2% compared to the previous year. Without the oil and gas sector's decline, the non-oil tradable sector's input to the overall economic growth was a positive 3.8%. Thus, the non-oil industry rose by 13.2% during the reported year.

Chart 15. Crude oil and natural gas production

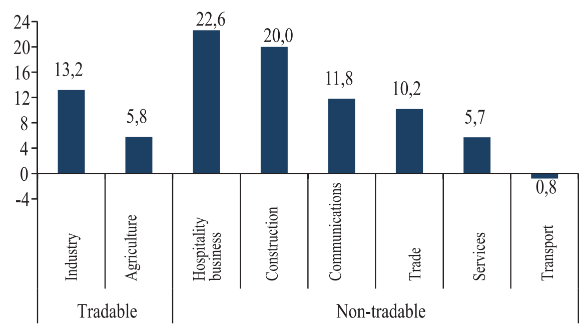


Source: SSC

Extraction of gold and silver was continued during the year; 1.8 tons of gold and 1.2 tons of silver were extracted in 2011.

Growth of the food industry, which makes up roughly a half of the non-oil sector, played a major role in the overall growth of the sector. Furthermore, machinery, metallurgy, chemical and clothes production also displayed high growth rates.

Chart 16. Non-oil sector growth by industries, %



Source: SSC

Agriculture registered a growth rate of 5.8% during the reported year, wherein crops accounted for 8% and livestock for 3.5%.

All areas of the **non-tradable sector**[3] except

[1] This number was calculated using the US Dollar’s exchange rate against the Manat. For international comparisons, this indicator should be calculated using the Purchasing Power Parity.
[2] The tradable sector includes agriculture and industry.
[3] The non-tradable sector includes construction, transport, communications, catering, hospitality business, etc.

transport showed growth. The added value generated by the non-tradable industries increased by 9.2%, contributing approximately 4 percentage points to the overall economic growth.

State Statistics Committee reported the services industry (hospitality business, post office and communications, trade, social services) to have had the highest growth rate of all non-tradable sectors. Services accounted for 35% of the total GDP and for 60% of the non-oil GDP.

Both government and international institutions expect the country's economic growth to continue in the near-term. IMF's projections estimate the country's economic growth rates for 2012 and 2013 at 3.7% and 1.9% respectively; the non-oil sector's growth forecast is 5.5-6% for both years[4]. Overall, UN, IMF, EBRD and WB's projections indicate a 3.5% growth rate for the country's economy in 2012.

The Central Bank's Real Sector Monitoring exercise (the RSM survey includes up to 300 entities) also supports the optimistic expectations of economic activity. The RSM findings suggest that the Business Confidence Index[5] in 2011 will improve against the previous year.

Box 4. Output gap

A number of interpretations of the output gap (OG) are found in economic literature. One of them suggests that OG represents the gap between the real and potential levels (highest level achievable with effective use of resources in the production cycle) of the GDP as a percentage. Another interpretation identifies the OG as a percentage-wise gap between the actual GDP and the potential level of production in case of elastic price balance. OG may be positive or negative. A positive OG indicates an overload of the labor resources of the production capacities and an excess of the aggregate demand over the aggregate supply; a negative OG indicates the opposite.

A number of various qualitative and qantitative indicators are generally used to assess the economy's OG. Periodic monitoring of the real sector with estimation of qualitative and quantitative indicators represents the widely used method of OG assessment. It should be noted that the CBA regularly monitors the real sector and evaluates the quality of the OG based on surveys and studies.

On the other hand, various statistic and econometric evaluations are available in literature for quantitative assessment of the OG. For instance, the Baxter and King methodology (1995), the Hodrik and Presscott approach (1980) are based solely on statistic methods. The Hodrik and Presscott methodology (1980) is based on the principle of minimizing the change combindation of the trend GDP (γ_t) by a trend component with the gap between the actual GDP (γ) and the trend GDP:

$$\min_{Y_T} \sum (Y - Y_T)^2 + \mu\left((Y_{T+1} - Y_T) - (Y_T - Y_{T-1})\right)^2$$

In this formulae μ is the mitigation parameter. The HP filter's weakness is that the definite number of observations complicates the correct estimation of the OG.

The metodology suggested by Beveridge and Nelson (1981) was one of the first quantitative assessment approaches for the OG. The Beveridge-Nelson decomposition divides the actual GDP by unobservable components, constant (trend) and temporary (cyclical) indicators.

Yet another methodology was developed by Blanchard and Kwuah (1989), VAR, which is based on the assumption that the potential portion of aggregate production is formed by the aggregate supply, while the cyclical portion is formed by the aggregate demand. Assuming that structural supply shocks have a permanent effect, while demand shocks have a temporary impact, the required parameters are identified by applying the necessary limitations to VAR.

The Kalman filter is also an effective methodology widely used for evaluation of unobservable components. This filter provides the dynamics of unobservable and observable components. The simplest Kalman filter for the output gap can be presented as follows.

$$\gamma_{t_*} = \gamma_t^* + g_{t_*}$$
$$\gamma_t = \mu_t + \gamma_{t-1} + \varepsilon_t^{\gamma}$$
$$\mu_t = \mu_{t-1} + \varepsilon_t^{\mu}$$
$$g_t = \varphi_1 g_{t-1} + \varphi_2 g_{t-2} + \varepsilon_t^{g}$$

Here, γ_t is the actual GDP, γ_t^* is the potential GDP, g_t is the cyclical component, μ_t is the potential GDP's drift, and ε_t is a statistical error. The GDP is divided by trend and cyclical components only using the actual timeline (time sequence).

An increase of the positive OG results in inflationary pressures, while an increase of the negative OG is interpreted as a sign of recession. An OG close to zero is considered optimal.

[4] Source: IMF, www.imf.org / Republic of Azerbaijan—Staff Report for the 2011 Article IV Consultation
[5] Business Confidence Index = (Production of Goods Index – Stock Reserve Index + Production Expectation Index)/3

Positive expectations were especially true of the chemical, construction material production and textile sub-sections of industry, as well as furniture and electric appliances sales segments of the trade sector. Services industry displays parallel trends, with the communications and hospitality business sub-sectors driving most positive expectations. Such positive anticipations also resulted in reduction of stock reserves in industry and trade.

In general, the CBA's RSM survey indicates an increasing number of businesses, which enhanced their scope of production and turnover during the year. For instance, the number of survey respondents who replied the question "any changes in your entity's economic activity?" with "reduction" halved in 2011.

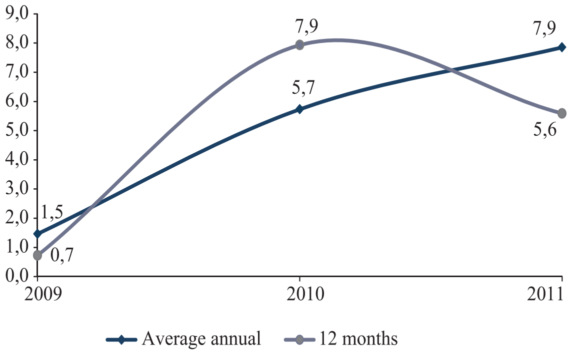
The Central Bank estimates the **output gap**[6] to have declined from the -4% of 2010 to -0.6% in 2011. This indicator is expected to rise up to the positive range and make 0.5% in 2012. Growth of public demand will play a key role in raising the output gap to the positive range.

2.3. Macroeconomic balance, price indices and employment

The country's macroeconomic stability was preserved against the decrease of the global inflationary processes and aggregate demand growing stronger in 2011. The growth of inflation was driven primarily by external factors during the year.

The annual inflation rate rose by 5.6%, **while the average annual increase of consumer prices** made 7.9%, mainly due to increasing food prices worldwide.

Chart 17. Consumer price index

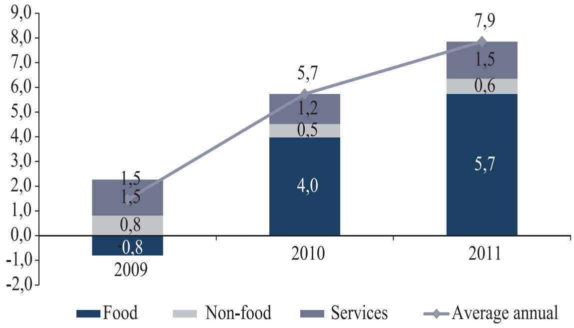


Source: SSC

[6] Gap between the potential and actual levels of the GDP.

Price increase on food products formed 5.7% percentage points of the average annual inflation rate, non-food products accounted for 0.7 percentage points and services for 1.5 percentage points. Average annual inflation rate on food products was 10.4%, while the year-to-date (December/December) rate was 7.1%.

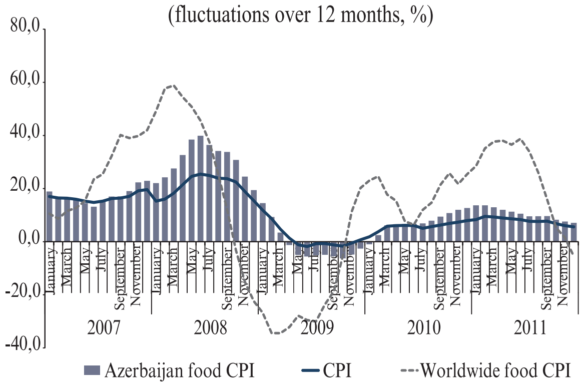
Chart 18. Average annual Consumer Price Index, %



Source: CBA's estimates based on SSC data

Average annual inflation rate on non-food products made 2.6%; year-to-date amounted to 1.2%. Cost of services increased by 5.1% against the year-start level, with the average annual growth rate amounting to 4.7%.

Chart 19. Food CPI for Azerbaijan and the world (fluctuations over 12 months, %)

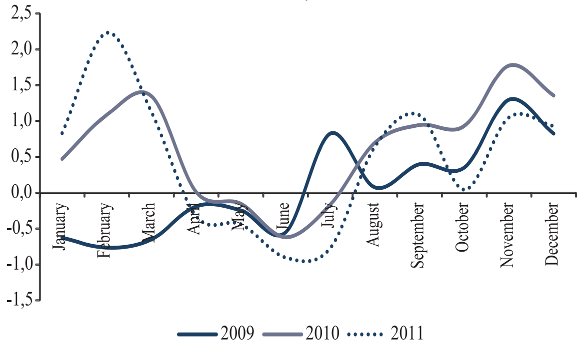


Source: SSC

Assessment of inflation in 2011 indicates that the price increase was mostly accounted for by food products. The food price increase was primarily due to the dramatic price increase on world food markets in the first half of 2011. The International Monetary Fund estimates that each 10% change in world food prices leads to a 3.2% change in food prices in Azerbaijan.

The deflation rate registered in April-July exceeded

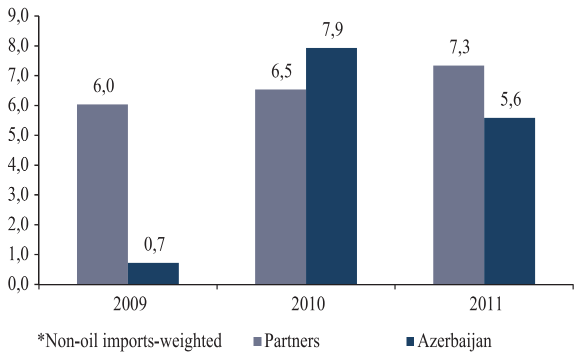
Chart 20. Monthly inflation rate, %



Source: SSC

that of the same period in the previous year, thus subjecting the change path of the annual inflation rate to greater volatility.

Chart 21. Consumer Price Index* (12 months), %

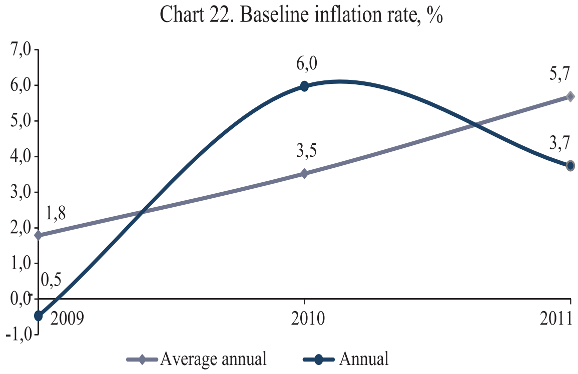


Source: SSC

The CBA's econometric estimates suggest that the money supply (+2.4%), inflation rates in partner countries (+2.5%) and seasonal factors (+1.9%) had an increasing, while the nominal effective exchange rate fluctuations (-1.2%) had a reducing effect on prices.

The average annual baseline inflation rate[7] amounted to 5.7%, and 3.7% as opposed to the beginning of the year level.

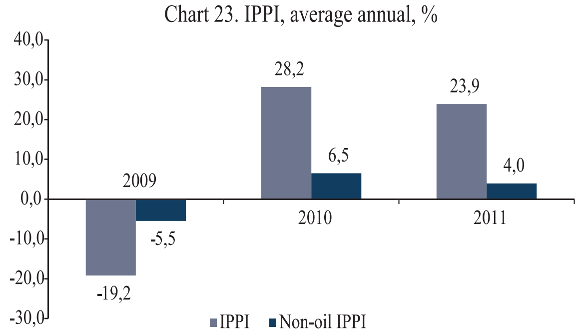
Chart 22. Baseline inflation rate, %



Source: SSC

The average annual industrial producer price index increased by 23.9% in 2011. The high growth rate of the industrial producer price index (IPPI) was driven primarily by the worldwide oil price increase. Thus, producer prices for extracting industries went up by the annual average of 27.8%, for textile industries by 27.1%, for chemical industry by 20.6%, for food industry by 13.4%, and for metal industry by 9%.

Chart 23. IPPI, average annual, %

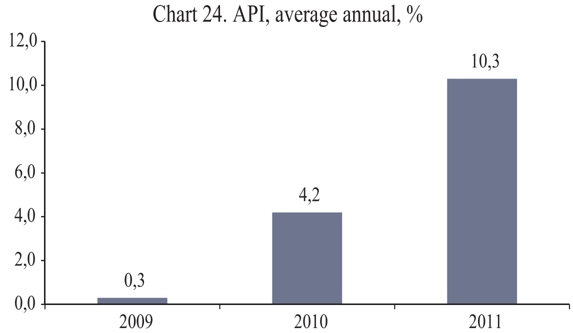


Source: SSC

During the year the IPPI rose by 4.0% on average. Alongside the increase of the producer price index some industries experienced a decline. For instance, the pharmaceutical industry's output went down by 1.5%, while electric equipment manufacturer's price decreased by1.8%.

The agricultural producer index (API) increased on average by 10.3% in 2011. The price change for the plant-growing industry made 20.3%, with livestock products rising by 11.3%.

Chart 24. API, average annual, %



Source: SSC

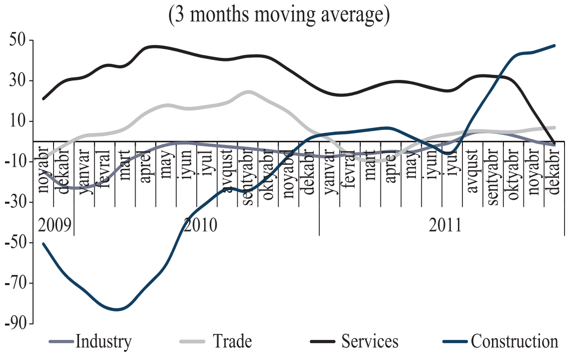
The country's **employment** rate was on the rise during the reported year. The headcount of economically active individuals totaled 4626.1 thousand, of which 4375.2 thousand were employed in various areas of economy and social sectors. The

[7] Baseline inflation rate is an inflation rate net of changes in government-regulated prices on goods and seasonal factors.

number of people on payroll increased by 0.2% during the year.

The CBA's real sector monitoring initiative covering roughly 300 entities also provides evidence of increased employment, as the monitored entities expanded their staff by a measure of 5% during the year.

Chart 25. Employment expectation index (3 months moving average)



Source: CBA

The CBA's study estimates employment expectations for the services and industrial sectors as negative, while trade and construction appear to be in the positive range.

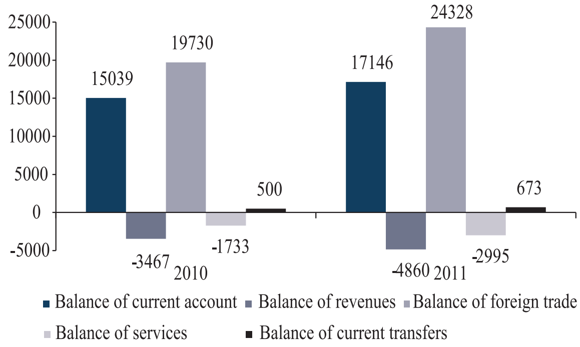
2.4. Balance of payments

As in the previous years, the oil and gas sector's foreign economic transactions arrived at a positive balance while the non-oil industry concluded the year with a negative balance.

Total revenues of the oil and gas sector were attributed to primarily by oil and natural gas exports and a stream of foreign investments funneled into the industry. The industry's expenditures represent profit and investment repatriation, imports of equipment and services. The total positive balance of the oil and gas industry amounted to USD25.7 billion in 2011.

In 2011 the **current account** generated a surplus of USD17.1 billion, with USD25.5 billion surplus in the current account for the oil and gas sector. That surplus fully covered the USD8.4 billion deficit of the non-oil sector's current account.

Chart 26. Balance of current operations, USD million



Source: CBA

The foreign trade turnover amounted to USD44.7 billion and arrived at a **positive** USD24.3 billion.

In 2011 Azerbaijan maintained trading relations with 153 countries across the globe. CIS countries are reported to have had a share of 12.5% in foreign trade while other foreign countries accounted for the remaining 87.5%. Azerbaijan further intensified

Table 3. Principal indicators of the balance of payments, USD mil

	2010	2011
I. Balance of the current account	15039.6	17146.1
Foreign trade balance	19730.4	24328.4
Balance of services	-1732.9	-2995.8
Balance of revenues	-3467.0	-4859.8
- Repatriation of investment revenues	-3591.8	-5148.8
Balance of current transfers	509.1	673.3
II. Balance of the capital and finance account	-4578.4	-4789.9
Direct investments	329.1	912.6
- To Azerbaijan	3347.3	4443.9
- To foreign countries	-235.7	-554.0
- Repatriation of investments	-2782.5	-2977.3
Loans and other investments	-4909.5	-5722.5
Petroleum bonus	2.0	20.0
III. Overall balance of payments (change in the country's strategic reserves)	10461.2	12356.2

Source: CBA

its trading affairs with Italy, France, USA, United Kingdom, Russia, Turkey, Germany, Ukraine, Japan and Indonesia (These countries accounted for 73.3% of the total trade).

produced from the Shakhdeniz field and USD1500.4 million is the share of the State Oil Company of the Republic of Azerbaijan.

The country's non-oil and gas exports in 2011 increased by 18.7% against the previous year, totaling USD1623.9 million.

Table 4. Principal foreign trade partners in 2011, USD mil

	Commodity turnover	Exports	Imports	Balance
Italy	9595	9341	254	+9087
France	4638	4039	599	+3440
USA	4086	3511	575	+2936
United Kingdom	3350	2853	497	+2356
Russian Federation	2884	1252	1632	-380
Turkey	2841	1624	1217	+407
Germany	1569	527	1042	-515
Ukraine	1443	931	512	+419
Japan	1404	1185	219	+966
Indonesia	926	913	13	+900
Others	11925	8319	3606	+4713
Total	44661	34495	10166	+24329
Including:				
CIS countries	5576	3075	2501	+574
Other countries	39085	31420	7665	+23755

Source: CBA

In 2011, **exports of goods** reached USD34.5 billion. Petroleum products accounted for 95.3% of the total exports.

USD31.6 billion worth of petroleum products were exported to foreign countries. Out of the total petroleum products exported petroleum processing products accounted for USD1.8 billion and crude oil exports for USD29.8 billion.

USD28.2 billion is the value of oil produced by the Azerbaijan International Operating Company (AIOC), out of the total oil exports. USD1.6 billion worth of crude oil exports were made by other entities, of which USD114.4 million pertained to the condensate

In the reported year **imports of goods** amounted to USD10.2 billion. Imports of consumer goods totaled USD3884.1 million, where food products accounted for USD1267.7 million.

Imports of machinery and equipment and goods financed by foreign investments accounted for 9.9% of the total imports thus amounting to USD1008.4 million. Out of this amount, imports of goods financed by investments used under the international oil and gas contracts totaled to 87%. Furthermore, industrial machines and equipment, chemical, ferrous

Table 5. Structure of exports

	2010		2011	
	Amount, USD mil	As percentage of total	Amount, USD mil	As percentage of total
Total exports	26476.0	100.0	34494.9	100.0
of which:				
1. Fuel and raw materials	25398.6	95.9	33435.6	96.9
- oil and gas products	25107.5	94.8	32871.0	95.3
- other raw materials	291.1	1.1	564.6	1.6
2.Machinery and equipment	336.1	1.3	177.7	0.5
3. Consumer goods	725.6	2.7	841.1	2.5
4. Other goods	15.7	0.1	40.5	0.1

Source: CBA

Table 6. Structure of imports

	2010		2011	
	Amount, USD mil	As percentage of total	Amount, USD mil	As percentage of total
Total imports	6745.6	100.0	10166.5	100.0
Of which:				
1. Consumer goods	2954.3	43.8	3884.1	38.2
- food products	1050.4	15.6	1267.7	12.5
- other	1903.9	28.2	2616.4	25.7
2. Investment quality goods	689.0	10.2	1008.4	9.9
- international oil and gas consortiums	559.0	8.3	877.5	8.6
- other	130.0	1.9	130.9	1.3
3. Other goods	3102.3	46.0	5274.0	51.9

Source: CBA

and non-ferrous metal products for a total worth of USD5274.0 million were imported to the country.

Mutual services held a special place in Azerbaijan's economic relations with foreign countries in 2011, amounting to USD8435.0 million. Of this, services provided by non-residents to Azerbaijani residents totaled to USD5715.4 million, and services provided by Azerbaijani residents to foreign residents amounted to USD2719.6 million. Net exports increased by 23% during the year, totaling USD24.3 billion.

Transportation services accounted for 20.5% of the **total services turnover**. 55.5% of the USD1727.8 million worth of transport services related to the use of foreign transportation systems by Azerbaijani residents.

The total value of transportation services provided by Azerbaijani residents amounted to USD768.5 million.

Travel-related services provided to foreign country residents in the reported year were USD1287.3 million. Of this, 36.1% pertained to business trips of foreign residents to Azerbaijan.

The total value of travel-related services provided by foreign countries to Azerbaijani residents amounted to USD1689.0 million, having gone up by 2.2 times. Of this, 62.3% represented the spending of Azerbaijani residents while traveling to foreign countries (excluding shuttle imports).

The **total turnover of revenues and payments** reached USD6897.3 million. Of this, 85.2% (USD5878.6 million) represented payments leaving Azerbaijan, while the core of that amount (USD4640.3 million) represents the repatriation of income of the Azerbaijan International Operating Company's foreign investors (mainly as crude oil and gas), remuneration to non-residents (USD141.3 million) and interest on foreign loans (USD248.6 million).

Transactions with foreign countries relating to **current transfers** totaled to USD3091.3 million in value. Of this, 60.9% represent the country's revenues.

94.1% of these revenues represent bank notes transferred from foreign countries to individuals, 1.7% humanitarian goods imported to the country and 4.2% other revenues.

Overall, the positive balance of current transfers totaled to USD673.3 million.

Foreign capital drawn to the country in 2011 totaled to USD8.1 billion. This indicator was driven primarily by foreign loans and direct investments drawn to the country.

Total investments drawn from foreign countries in the form of **direct investments** amounted to UD4.4 billion. The oil and gas industry accounted for 78% of the total investments. The national economy used these investments to finance large-scale oil and gas projects, mainly BP Exploration (Shakhdeniz) Ltd. project and operations carried out at the Azeri-Chirag-Guneshly field of the Azerbaijan International Operating Company.

Assessments set direct investments to the non-oil

Table 7. Structure of foreign investments drawn

	2010		2011	
	USD million	As percentage of total	USD million	As percentage of total
Direct investments	3347.3	40.3	4443.9	54.8
- oil and gas sector	2573.4	31.0	3465.6	42.7
- other sectors	773.9	9.3	978.3	12.1
Loans and other investments	4966.2	59.7	3651.0	45.0
- sovereign-guaranteed loans	735.5	8.8	1255.1	15.5
- loans w/o sovereign guarantees	2635.3	31.7	2053.0	25.3
- oil and gas sector	667.6	8.0	706.0	8.7
- banks	1686.6	20.3	828.9	10.2
- other	281.1	3.4	518.1	6.4
- other investments	1595.4	19.2	342.9	4.2
Petroleum bonus	2.0	-	20.0	0.2
TOTAL	8315.5	100.0	8114.9	100.0

Source: CBA

sector at a total of USD978.3 million. This amount represented 22% of the total direct investments accessed by the country.

Investments categorized as **loans and other investments** accounted for 45% (USD3651.0 million) of the total foreign investments. This amount was mostly formed from loans obtained directly by the government and those backed with sovereign guarantees, by the oil and gas sector and banks. 37.9% (USD1255.1 million) of that amount represented loans obtained directly by the government and those backed with sovereign guarantees (loans from international financial and other institutions); 62% (USD2053.0 million) million represents loans without sovereign guarantees, of which USD828.9 million were acquired by banks, USD706.0 million by the oil and gas sector, and USD518.1 million by other entities and firms.

USD2236.1 million was repaid on loans obtained in the previous periods. Of this amount, the banking system accounted for 43.4% (USD969.5 million), loans obtained directly or backed by the governments for 13.7% (USD306.9 million), the oil and gas sector for 25.8% (USD577.4 million), and other entities and firms for 17.1% (USD382.3 million).

The country's **financial assets (reserves)** increased by USD12356 million in 2011.

III. MONETARY AND EXCHANGE RATE POLICY, MONETARY CONDITIONS

3.1. Monetary policy

In 2011, the Central Bank's monetary policy followed the principal objective of maintaining a single-digit inflation rate, supporting the Manat's exchange rate, and strengthening financial sustainability. In pursuit of these goals, the Central Bank has been able to provide solid foundation for macroeconomic stability as well as to support the country's economic growth by making efficient adjustments to its policy, whenever necessary.

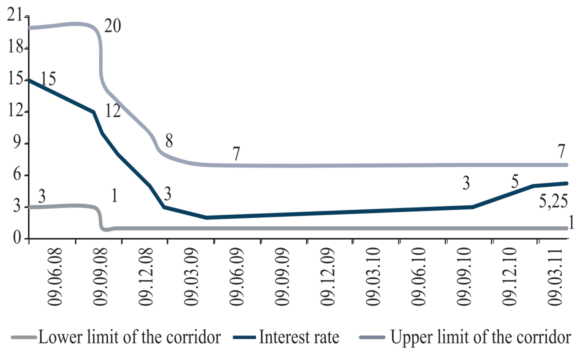
In consideration of the domestic demand tendencies coupled with external factors, the Central Bank pursued an **anti-inflationary monetary policy**, within the scope of its mandate.

A number of countries chose to make their monetary policies more stringent given the rising inflation during the year. The IMF's latest reports also advised a harsher monetary policy for developing countries in economic distress.

The cyclic indicators assessed regularly by the Central Bank also showed signs of ever-increasing tendencies supporting the notion of adjustments in the monetary policy.

Taking account of the invigorated aggregate demand, inflation factors and the projected balance of payments, the Central Bank decided to raise its interest rate from 3% to 5% on March 1, increasing it slightly more, to 5.25% on May 6. In addition to enabling a proper financial market environment, this measure was also designed to enhance the Central Bank's capabilities to sterilize the excess money supply.

Chart 27. Parameters of interest rate corridor, %



Source: CBA

As part of the overall effort to regulate the money supply, the **reserve requirements** for domestic and foreign liabilities of banks were raised in steps from 0.5% to 3% in 2011. Consequently, a total of AZN205 million was sterilized in required reserves, of which AZN63 million represented Manat-denominated

Table 8. Cyclic indicators

2011	Cyclic indicators	Late	In-phase	Preventive
January	Tight monetary policy	4	5	3
	Easy monetary policy	5	6	5
March	Tight monetary policy	4	6	3
	Easy monetary policy	5	5	5
June	Tight monetary policy	6	6	4
	Easy monetary policy	3	5	4
September	Tight monetary policy	7	7	4
	Easy monetary policy	2	4	4
January 2012	Tight monetary policy	7	7	5
	Easy monetary policy	2	4	3

Source: CBA

Box 5. Required reserves

Roughly 90% of central banks impose reserve requirements on commercial banks as an insurance for their obligations. Required reserves differ in form depending on their purpose. Required reserves serve 3 principal objectives:

Prudential – to provide a reserve to cover liquidity and settlement risks, as well as deposit withdrawals: as central banks tend to discharge their prudential and insurance functions mostly through supervision, deposit insurance, etc., the prudential purpose of required reserves is somewhat diminished.

Monetary supervision – to prevent the banks' balance sheet, money aggregates and inflation rate from growing: Required reserves are used as a monetary supervision tool in 2 ways: the money multiplier and the required reserve's impact on interest rate spreads. Bearing no to considerably below the market rate interest, required reserves affect and increase the spread between the interest rates on commercial banks' deposits and loans. Payment of interest for excess reserves to banks may be treated as a monetary policy red-flag.

Liquidity management – to manage the banking system's liquidity position by raising and decreasing reserve requirements: This is achievable by using non-interest bearing required reserves and interest bearing excess reserves. If paid on excess reserves, the interest rate could be used as the lower limit set for the interest rates on the interbank market. Maintaining required reserves using the averaging method may be one of the principal ways to mitigate market liquidity shocks and prevent volatility of short-term interest rates.

Furthermore, required reserves could be used as a **capital flow** control. To this end, non-interest bearing high required reserves are applied on deposits of non-residents. This policy is effective when capital flows are routed via banks.

Source: Simon Gray, "Balance of central banks and required reserves", IMF, February 2011

reserves and USD142 million foreign exchange-denominated reserves.

Open market transactions were also actively used during the period to manage the amount of liquidity in the economy. Outstanding notes increased by 2.3 times during the year.

The monetary policy managed to accomplish its principal goal of maintaining a single-digit inflation rate. The current inflation rate was driven primarily by the processes taking place on foreign markets and inflation rates of the trade partner countries.

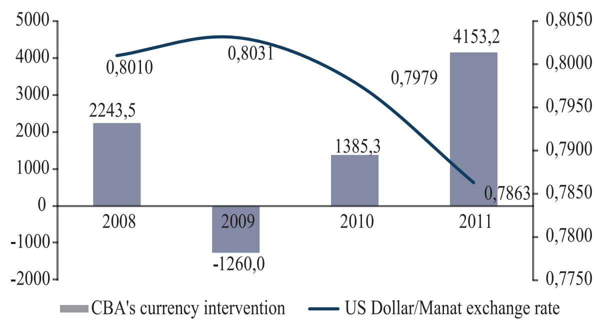
3.2. Exchange rate policy and international competitiveness

In 2011, the Central Bank conducted exchange rate policy using the new operational mechanism in an environment of expanding sources of supply on the currency market.

In consideration of the exchange rate policy diagnostics implemented in Azerbaijan in the past few years, the Central Bank's shifted its exchange rate policy towards **managing a USD/AZN two-way exchange rate within the interest rate corridor** in early 2011. Beside its communicative benefits, this instrument also improves the Central Bank's ability to switch to the floating exchange rate regime in the long run.

The large-scale surplus in the country's balance of payment tagged along an expansion of supply at the currency market. However, the Central Bank implemented USD4153.2 million worth of **currency sterilization** measures during the year in order to prevent the exchange rate from appreciating significantly and thereby to mitigate the negative effects on the non-oil sector's competitiveness.

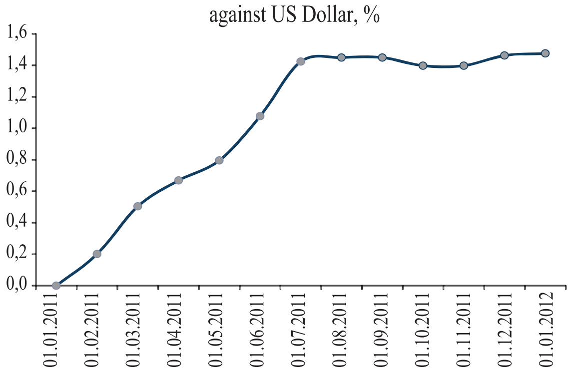
Chart 28. CBA's foreign exchange intervention, USD million



Source: CBA

As a result, the Manat's appreciation against the US Dollar was moderate, only 1.4%. A stable national currency had a positive effect on the country's macroeconomic and financial stability.

Chart 29. Changes of Manat's official exchange rate against US Dollar, %

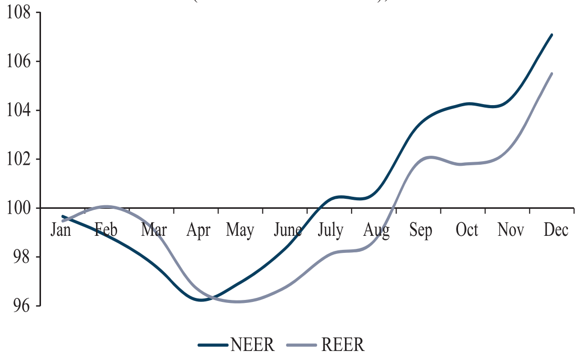


Source: CBA

The Manat appreciated nominally against the currencies of almost all trade partner countries. The change of Manat's nominal bilateral exchange rate impacted the real exchange rates as well. The Manat depreciated both in nominal and real terms against the Georgian and Chinese currencies, only nominally against the Japanese currency, and only in real terms against the Iranian currency. The Manat appreciated both in nominal and real terms against the currencies of countries like USA, Eurozone countries, Great Britain, Turkey, Russia, Ukraine, Kazakhstan, Israel, Belarus, South Korea. Of these, as a result of the dramatic devaluation of the Belarus Ruble, the Manat's nominal bilateral exchange rate appreciated by approximately 3 times against the Belarus Ruble.

The non-oil sector's **nominal effective exchange rate** (total trade turnover-weighted) in 2011 appreciated by 7.1%, which had a reducing effect on the inflation rate.

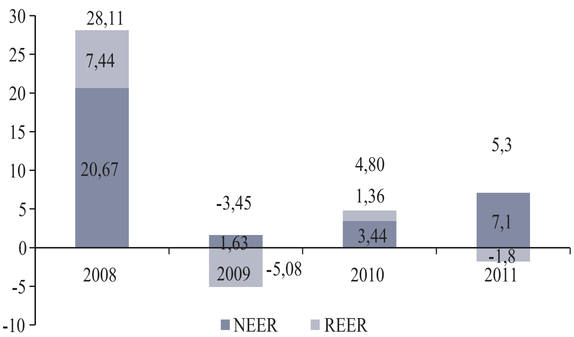
Chart 30. Non-oil sector's trade turnover-weighted exchange rate (December 2010 = 100), %



Source: CBA

The non-oil sector's **real effective exchange rate** of the Manat appreciated by 5.3% during the reported year. The difference between the inflation rates in partner countries and Azerbaijan had a reducing effect of 1.8% on the real effective exchange rate.

Chart 31. Structure of the REER, %



Source: CBA

Table 9. Bilateral nominal and real exchange rate indices of Manat in 2011, %

	As opposed to December 2010	
	Nominal bilateral exchange rate index*	Real bilateral exchange rate index
USA	101.6	104.2
Euro zone	101.9	104.6
Great Britain	101.7	104.1
Turkey	124.8	119.3
Russia	103.7	103.1
Ukraine	102.2	103.2
Georgia	95.7	99.1
Iran	107.4	94.5
Kazakhstan	102.0	100.2
Japan	94.9	100.9
Israel	106.3	109.8
China	97.0	99.3
Belarus	285.7	136.8
South Korea	101.7	102.8

**Average monthly change of the Manat's exchange rate against the partner country's currency.*

Source: CBA

The REER remained virtually flat relative to the developing countries accounting for over 80% of the non-oil exports.

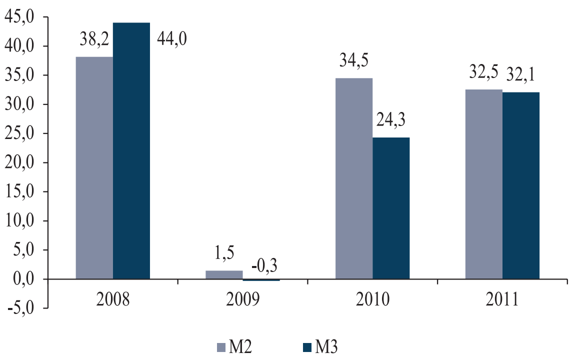
Thus, the Central Bank managed to maintain the Manat's two-way exchange rate stable as the balance of payments closed with a surplus in 2011. By intervening the currency market for sterilization purposes, the Central Bank kept the currency's market in balance while further enhancing its own currency reserves. The multi-lateral exchange rate of the Manat was affected by fluctuations of the bilateral exchange rate resulting from devaluations in some partner countries.

3.3. Money supply

In 2011, the money aggregate continued to grow dynamically, with its structure improving.

The Manat broad money (M2) increased by 32.5% to AZN10997.2 million during the year.

Chart 32. Changes of money aggregate, %

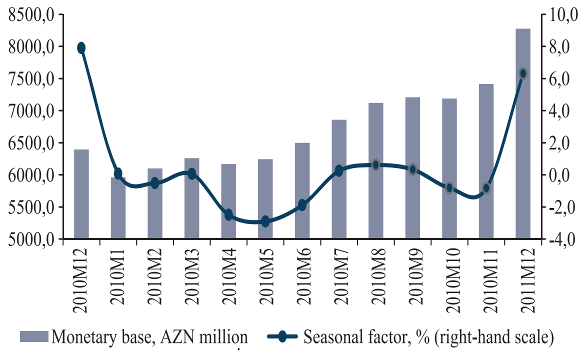


Source: CBA

The Manat monetary base had a growth rate of 29.3%.

The development path of the monetary base displayed no volatility; the growth rate only

Chart 33. Effect of seasonal factors on the monetary base

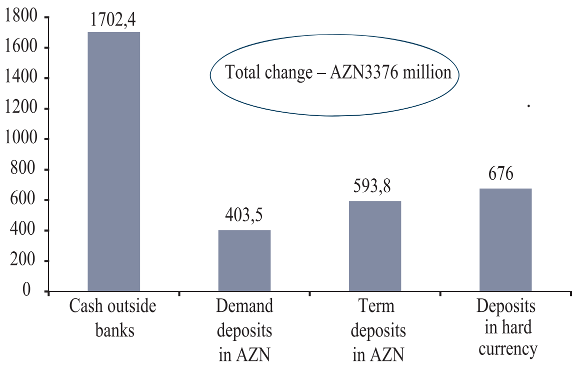


Source: CBA

somewhat picked up as affected by seasonal factors in December, which is attributed to the year-end social payments and other significant budgetary expenditures.

The broadly money (M3) increased by 32.1% against the beginning of the year, totaling AZN13903.2 million.

Chart 34. Changes of the M3 money aggregate, AZN million



Source: CBA

The broad money expanded due to the growth of both cash in circulation and non-cash money aggregate.

Table 10. Money aggregates, AZN million

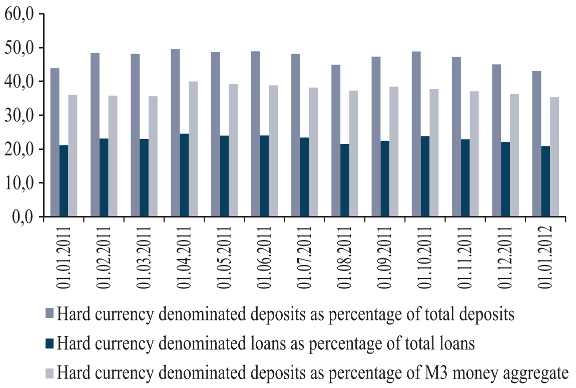
	01.01.10	01.01.11	01.01.12
M0 (Cash)	4147.8	5455.8	7158.2
M1 (Cash, individual and corporate demand deposits)	5239.8	6718.9	8824.8
M2 (Cash, demand and term individual and corporate deposits, AZN)	6169.2	8297.5	10997.2
M3 (Cash, demand and term individual and corporate deposits, AZN and hard currency)	8469.2	10527.5	13903.2

Source: CBA

Increased confidence of economic agents in the banking system resulted in a high growth of individual and corporate deposits during the reported year, with individual deposits in Manats accounting for the larger portion of the upturn.

No considerable changes were registered in the **dollarization** indicators during the year.

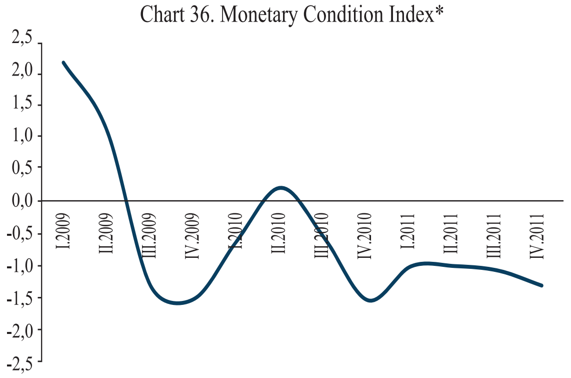
Chart 35. Dollarization indicators, %



Source: CBA

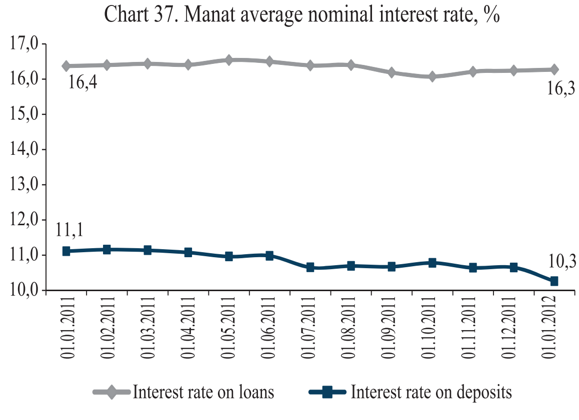
The relative appreciation of the Manat's multilateral nominal exchange rate and the growth of the money supply had a mitigating effect on the **Monetary Condition Index** (MCI)[8].

Chart 36. Monetary Condition Index*



Source: CBA

Chart 37. Manat average nominal interest rate, %



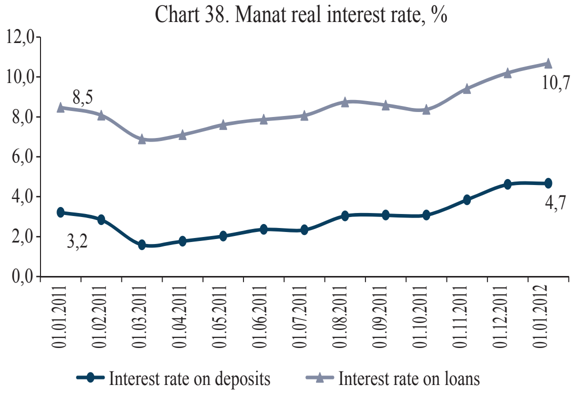
Source: CBA

The MCI has remained generally moderate despite the Central Bank's decision to maintain the monetary policy's parameters "neutral" and the relatively higher pace of inflation.

No substantive changes were noted in the average-weighted **nominal interest rates** on Manat and foreign exchange denominated loans and deposits during the reported year.

As the inflation rate somewhat increased during the reported year relative to the same period of the previous year, the real interest rates rose as well.

Chart 38. Manat real interest rate, %



Source: CBA

Foreign exchange denominated real interest rate followed the same development path.

3.4. Institutional framework of the monetary policy

In 2011, the Central Bank carried on with its programmed efforts aimed at conceiving and structuring an institutional framework for macroeconomic management and monetary policy.

The Central Bank's Monetary Policy and Financial Stability Committee (MPFSC) continued to operate and held 12 meetings during the reported year. The Committee regularly monitored the macroeconomic situation to substantiate its analysis of external and internal factors and make informed and adequate policy decisions. These decisions related primarily to the parameters of the exchange rate and monetary policy tools and addressed the principal objectives of the financial stability policy. Proposals were developed and adopted by the MPFSC regarding changes in the operational parameters of the exchange rate policy, as part of the consistent efforts to liberalize the exchange rate environment.

[8] MCI is a ratio that characterizes the average change of the money aggregate and the nominal effective exchange rate based on their percentages.

In 2011, the Central Bank moved further on towards streamlining the monetary policy tools to conformance with the **post-crisis challenges** and international best practices. Studies were conducted to support the development of counter-cyclical macro prudential management in Azerbaijan. In this connection, the Central Bank drafter a preliminary strategy for its monetary and financial stability policy.

The reported period also saw the Central Bank's continued efforts aimed at developing and putting in place a research framework that would ensure effectiveness of the monetary policy and financial stability policy.

As part of the overall efforts to provide a greater and **deeper coverage of empirical research** and studies, risk identification, verification and management were

Box 6. Models employed by the Central Bank

Model for Evaluation of the Inflation Determinants Model: 2 empirical approaches were used in order to identify the macroeconomic fundamentals affecting inflation across the country's economy and to evaluate the extent of their effect:

Linear model evaluation;

VAR model evaluation.

Both approaches incorporated the Nominal Effective Exchange Rate (NEER), money aggregate (M1) and prices in partner countries (CPIx) as factors affecting inflation.

It should be noted that under the linear evaluation approach the money aggregate's impact on inflation occurs with a month's lag, wherefore a 10% increase of the money aggregate results in a 2.6% increase of inflation.

Unlike the linear model, the VAR model's effect is not one-sided as the model scrutinizes the mutual connection between the variables. The transmission channel is conceived as a chain of causality as follows under the VAR model:

NEER→M1→CPI

Model for Manat's Exchange Rate Pass-Through Into Inflation: The research focused on asymmetric and non-linear evaluations of the exchange rate transmitter, quantifying the effect of exchange rate fluctuations on domestic prices and assessing Azerbaijan-specific characteristics of pass-through.

Assessments made using the VAR model suggest that changes in the NEER affect the M1 money aggregate and, consequently, the CPI is subjected to the gross effect of such changes. Following an assessment of the mutual connection between the variables, the price pass-through was estimated.

Model for Evaluation of Real Estate Market Bubbles: The model identified the demand and supply factors affecting real estate market prices, which were subsequently used to determine the balanced price levels and the extent to which the actual level deviated from the balanced level.

The balanced level of the secondary and primary market prices was identified in order to determine the scope of Azerbaijan's real estate market bubbles. Econometric estimates indicate that real income remaining at disposal of households, real estate loans represent demand factors at both markets, while the exposition term is only true for the secondary market.

Balanced levels were identified for both demand and supply factors at the primary market, and for demand factors at the secondary market, based on the IMF's methodology.

Dynamic-Stochastic General Equilibrium (DSGE) for Azerbaijan. The Central Bank built the DSGE model in order to identify the economic cycles affected by external and internal stochastic shocks, analyze the connections between macro-fundamentals, as well as to develop their mid- and long-term projections.

The DSGE model determines the balanced level of the endogenous fundamentals (real economic growth, real effective exchange rate, inflation rate, capital, investments, salary, foreign trade and interest rates and consumption, etc.) based on the behavior of micro-subjects.

The model's theoretical set-up incorporates the exogenous consumer's habit inertia, differential labor supply and intensive profitability, gradual optimization or mark-to-inflation indexing of salaries, differentiated interim product, non-elastic prices and various monetary regimes. The DSGE model was calibrated and evaluated using the available literature and the country's performance statistics.

The DSGE model allowed for simulating the effects of a number of monetary regimes on the macroeconomic fundamentals. For instance, the effects of technological and oil price shocks were estimated under the fixed exchange rate and target inflation rate regimes.

Source: CBA

prioritized among others with an aim to evaluate the financial stability and build relevant management capacities. Weaknesses and strengths of the financial system were identified using stress-tests and financial stability indicators; the banking sector's sustainability and sensitivity were regularly assessed. Evaluation of an optimal level of concentration in the banking system was initiated and exports financing mechanisms of Azerbaijani banks were studied.

Discussions were continued involving foreign experts regarding liberalization of the exchange rate environment and impacts of exchange rate fluctuations on real sector industries were evaluated, as part of the monetary policy improvement initiative.

New studies were conducted focusing on expanding the outreach of the banking system's financial intermediation functions; the current policy reflects the findings of the said studies.

As part of the **econometric model improvement** initiative, the Central Bank assessed the asymmetry of the exchange rate's pass-through into inflation and periodic stability in Azerbaijan. Furthermore, the study also addressed the issue of identifying the critical threshold of inflation for Azerbaijan and initiated an assessment of the Panel VAR model for oil exporting countries. To this end, sources of economic fluctuations in oil exporting countries (Azerbaijan, Kazakhstan, Russia and Iran) were researched.

A Dynamic Stochastic General Equilibrium model was built for analysis and projection of macroeconomic indicators; econometric evaluations and improvements were made.

A simulation of Azerbaijan's economy was carried out based on the model's mathematical and analytical specifications. Works are currently underway to build a working documentary format of the model taking account of the country's unique micro- and macroeconomic economic specifications.

Seeking to evaluate the Central Bank's response function, assessments conducted in various countries using Taylor's rule were studied, following which a relevant methodology was developed for Azerbaijan. To this end, the output gap of the money aggregate, exchange rate and oil price and their effects on the gaps between the potential and actual inflation rates were evaluated.

Currency substitution and econometric assessment studies were conducted in Azerbaijan using special econometric methods. Furthermore, Azerbaijan's opportunities for geographic and currency make-up diversification of its foreign exchange reserves were researched. The near-term (2012-2015) research agenda includes strategic planning, macro- and micro-economy, global economy, social and economic development programs, financial sector development.

Among other focal points of engagement in 2011, the Central Bank sought to further improve and harmonize its **statistical data management** procedures with best international practices. Hence, the Bank proceeded with the project of setting up the Electronic Database and Analytical Reporting System (ESAS) that will essentially be a multi-functional, user-friendly single-source statistical database. In addition, the Bank continued its efforts to harmonize its Balance of Payments preparation procedures with the IMF's new methodology (6th edition).

The CBA continued to monitor the real sector in the reported year. As part of this initiative, the Bank increased the number of entities it monitors for macroeconomic purposes, and refined its methodology for developing business activity indices. The CBA currently monitors approximately 300 entities representing trade, industrial, services and construction industries.

In addition to all of the above, the Central Bank developed an **intellectual resource development** concept with an aim to support future research work. This concept envisages a range of projects such as the Virtual Central Bank Laboratory, an electronic library, financial awareness and economic knowledge portal.

IV. FINANCIAL MARKETS

4.1. Foreign exchange market

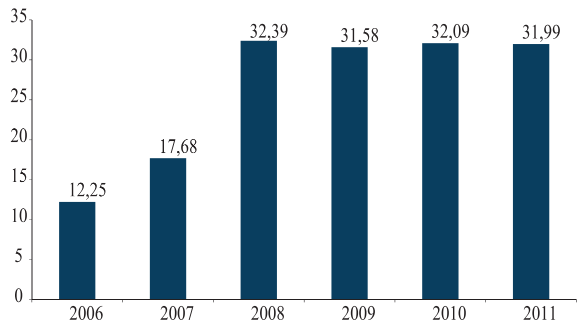
As the domestic foreign exchange market displayed a considerable excess of supply over demand in 2011, the Central Bank's currency market-related efforts under the "intervention corridor" were aimed at sterilizing the excess currency supply, all the while seeking to enhance the market's transparency and liquidity.

With the purpose of ensuring transparent operation of the foreign exchange market, interbank foreign exchange transactions were executed using the **Bloomberg-based uniform electronic trading platform** in the reported year. Transition to the new trading system has enabled the traders to monitor changes in the USD/AZN exchange rates, volume indices of trading transactions and average-weighted exchange rates, foreign exchange demand and supply in real time.

24 banks have already joined the system, wherein they declare exchange rates for the USD/AZN currency pair and close transactions on a daily basis. Thus, the Bloomberg system accounts for 93% of the interbank foreign exchange market's overall transactions involving the USD/AZN currency pair from the date the system was put in operation. The system has developed indices reflecting the volumes (AZRRTRVU, AZRRTRVO) and exchange rates (AZRRLTPR, AZRRVWAP) of transactions.

The reported year demonstrated the same stability of foreign exchange market transactions as displayed by the previous year. Thus, total **foreign exchange market transactions** amounted to USD32 billion, having virtually remained unchanged against the previous period.

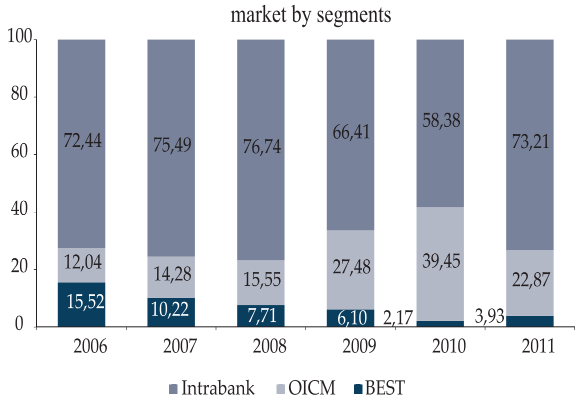
Chart 39. Total foreign exchange market transaction, USD billion



Source: CBA

In the reported year, the share of the foreign exchange market's intrabank transactions increased to 73%.

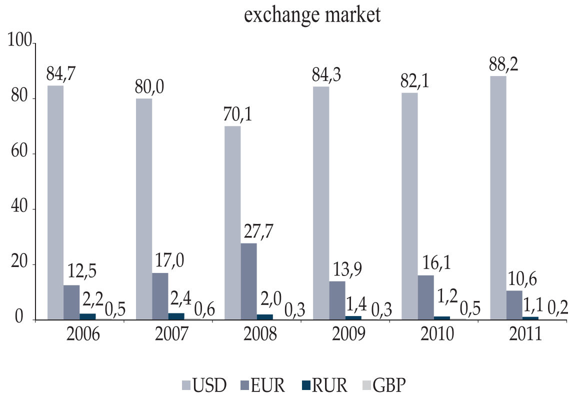
Chart 40. Distribution of the domestic foreign exchange market by segments



Source: CBA

The USD transactions at the domestic foreign exchange market retained their significant share (88%) in the reported year.

Chart 41. Currency structure of the domestic foreign exchange market



Source: CBA

With an aim to prevent the Manat from over-appreciating, the Central Bank initiated USD4 billion worth of **currency sterilization** efforts.

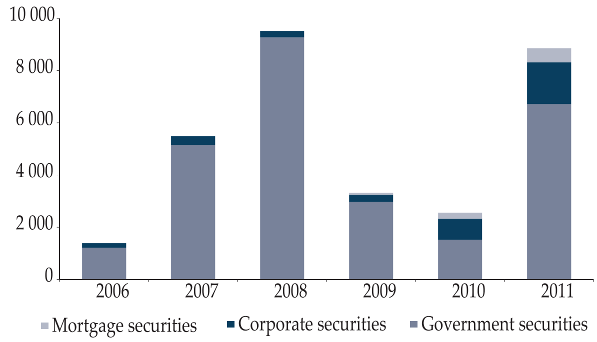
During the year the Manat's **official nominal exchange rate** against the US Dollar appreciated by only AZN1.1, or 1.43%. The growth took place mainly in the first half of the year.

4.2. Money market

The securities market continued to grow in volume, while the range of money market tools expanded in 2011.

In 2011, the **securities market** increased by roughly 3.5 times, totaling AZN8.9 billion. The government securities market accounted for 75.8% (of which 95.8% pertained to short-term notes), and the corporate securities market for 24.2% of the overall securities market.

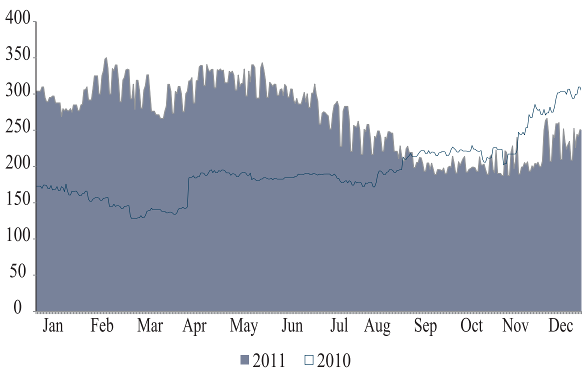
Chart 42. Organized securities market, AZN million



Source: CBA

By the year-end outstanding government securities declined by AZN59 million or 19% from the previous year's level (AZN303.9 million), down to AZN250.7 million.

Chart 43. Outstanding government securities, AZN million



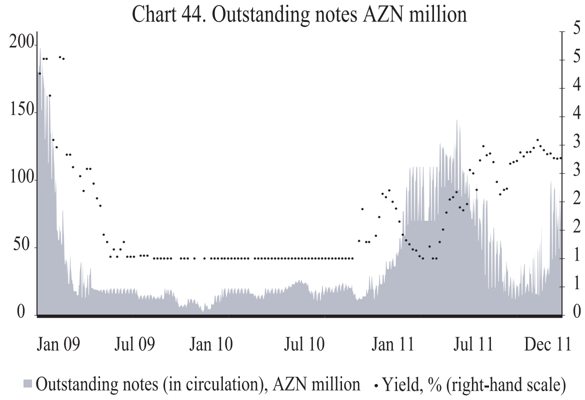
Source: CBA

At the year-end the share of outstanding government securities rose from 11% to 36%, while the share of T-bills decreased from 89% to 64%.

During the reported year AZN1307 million worth of the **Central Bank's short-term notes** were issued, of which AZN777 million (59.4%) were offered through auctions. AZN618.25 million worth of notes, nominally, or 79.57% of the total issue were sold during the period. The average yield of notes at the last auction was 2.77%. This indicator had made 2.2% at the beginning of the year.

Notes outstanding (in circulation) increased by AZN51.2 million (including repo transactions) or 2.3 times against the previous year thus totaling to AZN91.2 million at the year-end.

Chart 44. Outstanding notes AZN million

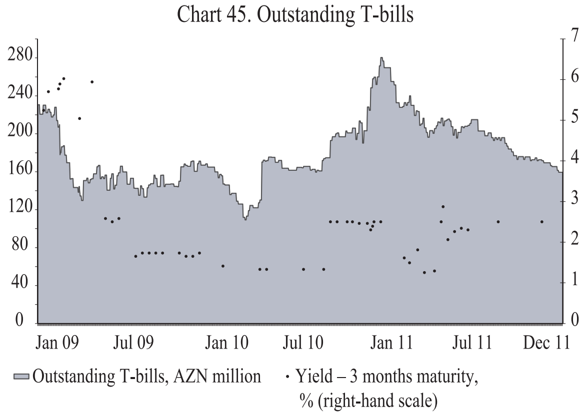


Source: CBA

Transactions involving framework instruments amounted to AZN5373.2 million during the period, all of which were represented by repo transactions. The year-end interest rate on framework instruments equaled 1% for overnight repo transactions and 7% for overnight counter-repo transactions.

The year-end **government bonds (GB's)** decreased by AZN110.3 million or 40.88% against the year-start rate equaling AZN159.44 million. Average yield on one year maturity GB's resolved at 4.00%.

Chart 45. Outstanding T-bills



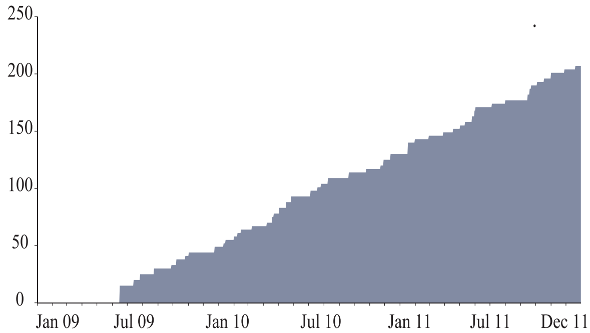
Source: CBA

During the year the Ministry of Finance issued short-term securities (2 and 3 years maturities) and revocable government bonds in addition to the short-term bonds.

[9] Bura Mərkəzi Bankın qısamüddətli notları və Maliyyə Nazirliyinin istiqrazları daxildir.

During the year, the Azerbaijan Mortgage Fund registered the data sheet for the 4th issue of 7 year maturity unsecured bonds for a total of AZN20.0 million. 15 auctions were held to sell AZN60 million worth of bonds under the 3rd issue's data sheet, and 5 auctions to sell AZN17 million worth of bonds under the 4th issue's data sheet in 2011. Outstanding bonds at the year-end totaled to AZN207 million. In addition, the data sheet for the new 5th issue was registered for AZN30 million worth of **mortgage-backed securities** at the year-end.

Chart 46. Outstanding mortgage-backed securities, AZN million



Source: CBA

Secondary market transactions for mortgage backed securities totaled to AZN463.4 million (71 transactions). The mortgage-backed securities market increased by AZN315.7 million against the previous year.

4.3. Interbank market

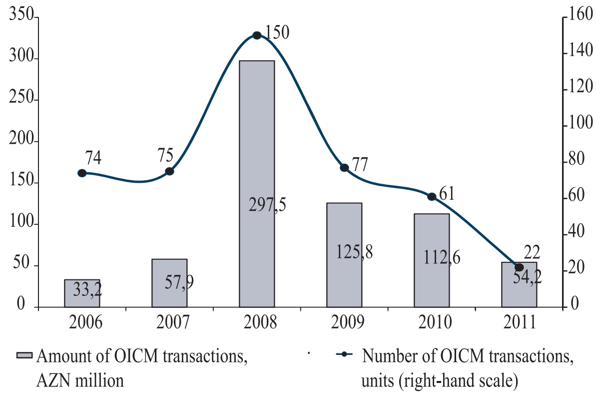
The interbank money market continued to operate in 2011, with some of its segments invigorated.

In 2009 the **Organized Interbank Credit Market (OICM)** carried out AZN54.2 million worth of 22 transactions. Transactions have been on a declining string for three consecutive years, both in terms of amount and number.

The Secured Money Market, a segment of the Organized Interbank Credit Market established with the Central Bank's support in 2010 with an aim to revitalize the money markets, increased by AZN12.5 million (9 transactions).

Unlike the OICM, the **Organized Interbank Repo Market** showed growth of transaction amounts. İl ərzində bu bazarda banklar tərəfindən 58,7 mln.

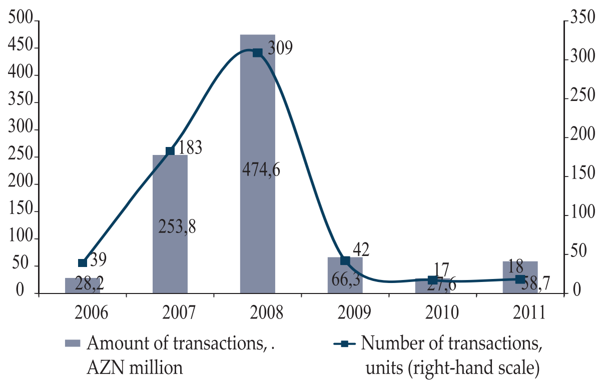
Chart 47. Organized Interbank Credit Market



Source: CBA

Banks conducted AZN58.7 million worth of 18 transactions at this market.

Chart 48. Interbank Repo Market



Source: CBA

V. FOREIGN EXCHANGE RESERVES MANAGEMENT

As in the previous years, in 2011 the Central Bank managed its foreign exchange reserves based on strategic pillars of safety, liquidity and profitability and operating investments.

The Central Bank had to manage the foreign exchange reserves in consideration of the continuing instability of the world financial markets, increasing global financial risks and interest rate cutbacks in 2011. Given the global situation, the Central Bank's investment policy with respect to the reserves primarily sought **to preserve its assets** as a top priority during the reported year.

The reserves through a sub-division into investment tranches, which represent an instrument of operation and recovery underpinning the current activities. **Currency diversification** remained the principal component of the management strategy.

The operating tranche was quantified in consideration of providing proper support to the monetary policy and exchange rate environment as well as precluding adverse impacts of currency crises. The currency set-up of the tranche is consistently maintained taking account of the currencies that constitute the very core of the country's foreign trade balance and liabilities. Thus, 85% of the tranche were held in the US Dollar, the dominating currency of foreign trade and the country's foreign liabilities, and 15% in Euro, while the investment tranche was divided between the US Dollar, Euro and British Pound.

With the principal objective of reserve management being diversification of the foreign exchange reserves, reduction of sensitivity to global shocks and preservation of the absolute value of reserves, the investment tranche was maintained in USD0.66, Euro 0.423 and GBP 0.111 that constitute the SDR (modified SDR) basket, excluding the Japanese Yen, as defined by the International Monetary Fund[9].

During the year the **Central Bank carried on with its efforts to build and foster domestic capacities for foreign exchange reserves management**. In this view, the Bank scrutinized the possibilities of introducing state-of-the-art management methods at all levels of the investment process, and developed an asset strategic distribution methodology and mathematical models to support the inclusion of new investment quality assets to the portfolio. The Central Bank maintained its focus on the continuing upgrade of the IT infrastructure and efficient supply of data as they are instrumental in foreign exchange reserves management.

Relevant international certification (CFA) was promoted as part of the **human resource development** efforts. Meanwhile, the Bank's domestic capacity building efforts continued to benefit from the technical assistance under the "Reserve Management and Advisory Program" developed specifically for central banks by the World Bank's Treasury.

Furthermore, in 2011 the Central Bank continued its **partnership with international financial institutions specialized** in asset management.

In 2011, the Central Bank's currency reserves totaled to USD10 481.5 million, having increased by USD4 073.9 million or 63.6%, through the domestic currency market interventions and **revenues generated from asset management**. Assets under management amounted to USD10 535.2 million, of which 3% is managed by external managers. The interest yield/rate of return on management of currency assets amounted to 0.57%.

[10] This structure incorporates the IMF's amendments of December 30, 2010

VI. BANKING SYSTEM AND FINANCIAL STABILITY

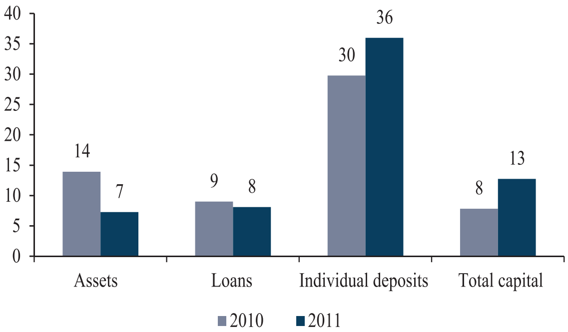
6.1. Change path and institutional development of the banking system

The banking sector managed to maintain its development pace in 2011, while further deepening its financial intermediation function.

Total bank assets increased by 7%, total loan portfolio by 8% in 2011. Banks developed a stronger capital position, securing greater public confidence.

The ratio of bank assets to the non-oil GDP amounted to 64.9% in 2011, ratio of equity to the non-oil GDP to 9.7%, loans to economic sectors to 44.1%, while deposits of individuals to 18.7%.

Chart 49. Growth rates of principal banking indicators, %



Source: CBA

The **enhancing role of mid-sized banks** continued as a major trend in the banking system's development in 2011. Thus, large banks (top 5 banks in terms of assets) had their share of total bank assets reduced from 61% to 57.0% and share of loans to economic sectors from 65.8% down to 56.5%.

Having learned their lessons from the global crisis, banks in Azerbaijan continued **to enhance their internal institutional capacities** in 2011. Banks showed a stronger bend towards corporate governance standards and state-of-the-art technologies, while also investing a greater measure in human and technological capital.

Institutional and infrastructural efforts continued as part of the banking system's development had an increasing effect on the **banks' attractiveness for foreign investors** in 2011. The number of banks with foreign capital increased from 22 to 23, while total foreign equity investments in banks reached AZN296 million through an AZN50.6 million (20.8%) gain.

International ratings also herald the banks' increasing act at the foreign financial market scene, entailing reputational boosts. Presently 11 banks have international ratings. Local banks managed to

Box 7. Systemic financial institutions

Systemic risks are regarded as setbacks in access to financial services and adverse effects on the real sector as a result of deteriorations in the financial system's performance. Systemic financial institutions are instrumental in assessing systemic risks.

Three criteria are used to identify whether financial institutions are systemic. These criteria either directly or indirectly reflect on impact channels. The direct impact is found in the size and replaceability degrees, while the indirect impact shows through interconnections. These criteria include:

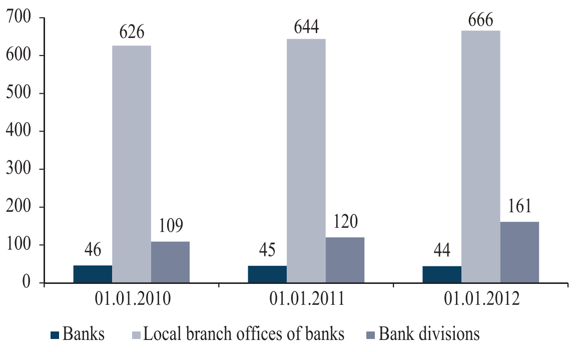
1. Size. Services provided by financial institutions as a percentage of the financial system represent one of the determinants of systemic significance. The higher the transaction share of financial institutions, the greater the systemic significance they represent on the market.

2. Replace ability. Some financial institutions play a key role in the economy. They are considered systemic not because of their great size or connections with other institutions, but due to the special nature of services that they provide. Such institutions may include payment and clearing systems, custodial services, etc.

3. Interconnection. An individual financial institution's problems are passed on to the entire financial system because of an interconnection among the financial system's components.

Source: the Basel Committee for Bank Supervision maintain their international ratings intact while the world's leading rating agencies downgraded a number of banks in developed countries. Furthermore, 39 local banks were audited by international auditors. These banks account for 99% of the total bank assets.

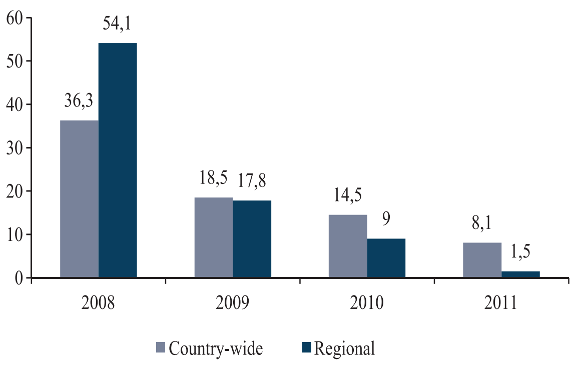
Chart 50. Structural network of banks, units



Source: CBA

Banks continued **to expand their branch office network and other structural divisions** in order to address the economy's needs for financial services and improve customer access to financial services. 26 new branch offices were opened for business in 2011; thus, the number of bank branch offices totaled to 666. 46 new bank divisions were opened; the number of bank divisions thus reached 161.

Chart 51. Annual growth rate of loans, %



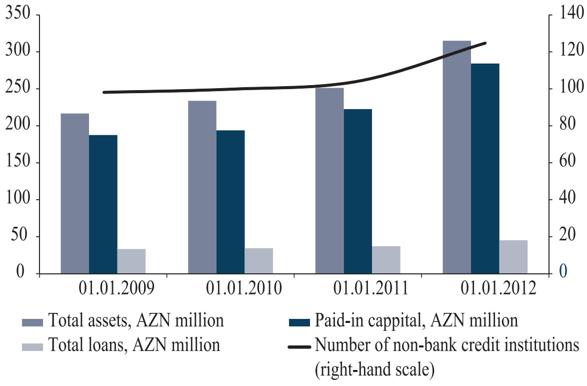
Source: CBA

12 of the new branch offices were established in different regions. As at 01.01.2012, 328 bank branch offices (49.2% of the total) operate in regions.

The number of other financial institutions that provide limited banking services also increased in parallel to the banking system's development. They include **non-bank credit institutions**, including credit unions, non-bank credit institutions and other kinds of financial institutions rose to 125 in number (101 at the beginning of the year), while their branch offices increased up to 86 (69 at the beginning of the year). The Central Bank granted licenses to 9 new non-bank credit institutions, and 19 new credit unions during the reported year.

In parallel to the increasing number of non-bank credit institutions their transactions also gained on in terms of volume. Thus, the total assets of such institutions increased by 25.4%, while their lending increased by 27.8% during the year.

Chart 52. Main indicators of non-bank credit institutions



Source: CBA

The expanded geographic coverage of the banking infrastructure enhanced the access of economic agents, especially **individuals to banking services**. Presently, 12.5 (11.3 at the beginning of the year) banks and non-bank credit institutions and their divisions provide financial services to every 1000 m^2 and 17.4 (16.1 at the beginning of the year) to every 100.000 individuals of age.

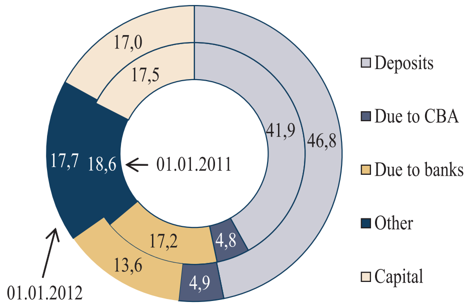
6.2. Liabilities of the banking system

The banking system continued to forge a stronger resource base by raising funding from more sustainable sources in 2011.

In 2011, the total bank liabilities reached AZN11831.7 million having increased by AZN1662 million or 16.3% (15.1% in 2010). In the reported year, funds (deposits) drawn from legal entities (non-financial institutions) and individuals traditionally had a large share in the set up of the banks' resource base. Individual and corporate deposits increased substantially during the reported year, consistently with the enhancing confidence of economic agents in the banking system. This growth was largely attributable to individual deposits.

In 2011 **deposits** received from internal sources (other than non-financial entities) totaled AZN6927.4 million having decreased by AZN1478.4 million (27.1%). The year-end total deposits represented 58.5% of the total liabilities and 48.6% of the total resource base.

Chart 53. Structure of the banking sector's liabilities, %

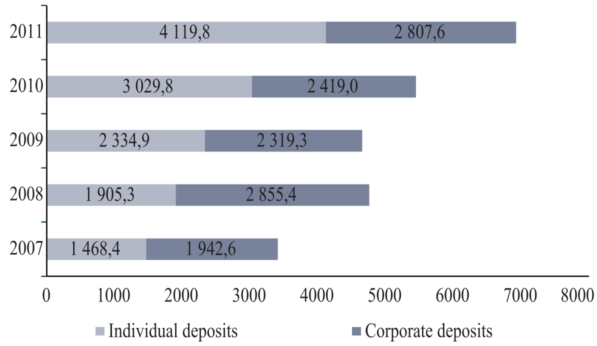


Source: CBA

In 2011, **individual deposits** increased by 36% to AZN4119.8 million (the growth rate was 29.8% in 2010), while corporate deposits (including deposits from government entities) increased by 16.1% to AZN2807.6 million at the year-end. Individual deposits represented 34.8% of the total bank liabilities as at January 1, 2012 (29.8% as at January 1, 2011).

The deposit base displayed positive changes in terms of quality in addition to the quantifiable growth. **Term deposits** increased as a percentage of

Chart 54. Structure of deposits (at year-end), AZN million



Source: CBA

the total individual deposits: while individual current accounts rose by AZN269.7 million, term deposits went up by AZN820.4 million.

The **currency set-up of deposits** improved alongside their maturity structure. The dollarization level declined during the year as the Manat's exchange rate remained stable. Thus, national currency-denominated individual deposits increased by 62%, rising up to 55% of the total deposits by the year-end.

No substantive occurred in the depositor structure, as resident individual depositors represented 91% and non-resident depositors accounted for 9% of the total individual deposits.

Funds obtained from the Central Bank amounted to 4.9% of the banking sector's year-end total liabilities (4.8% as at January 1, 2010).

Box 8. Classification of liabilities

Alongside a comprehensive analysis of the loan portfolio, analysis of funding sources is essential for banks to minimize the liquidity risk. Bank liabilities may be classified as follows in terms of ability to generate the liquidity risk:

Core liabilities – individual term and demand deposits. These funds represent the most reliable base for banks. Such liabilities tend to grow in consistency with the nation's welfare.

Mid-level liabilities – these include deposits of non-financial institutions and characterized with pro-cyclical behavior consistent with business cycles.

Non-core liabilities represent liabilities to financial institutions. When loans grow faster than deposits in times of credit booms, alternative funding sources are used, in particular, funds obtained from other domestic and foreign banks. These funds are sensitive to changes at domestic and foreign financial markets.

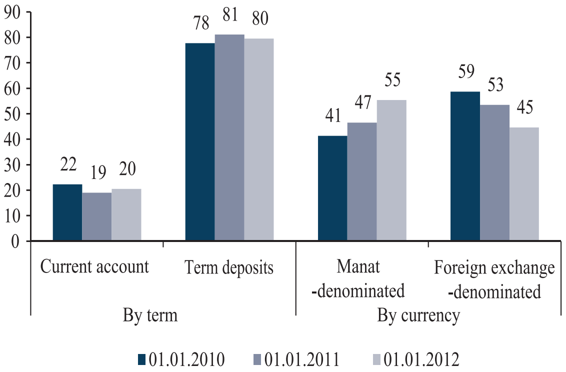
High liquidity (current) liabilities – beside correspondent accounts and overnight deposits, such liabilities include all current accounts, demand deposits, terms liabilities with maturities under 30 days (including securities issued by the bank), matured liabilities, opened irrevocable lines of credit without contractual restrictions of time of use.

Medium liquidity liabilities – these include term liabilities with maturity from 30 to 365 days (including securities issued by the bank), debt obligations with maturity over one year contractually redeemable before the maturity date.

Low liquidity liabilities include liabilities with maturity over 365 days.

Source: CBA

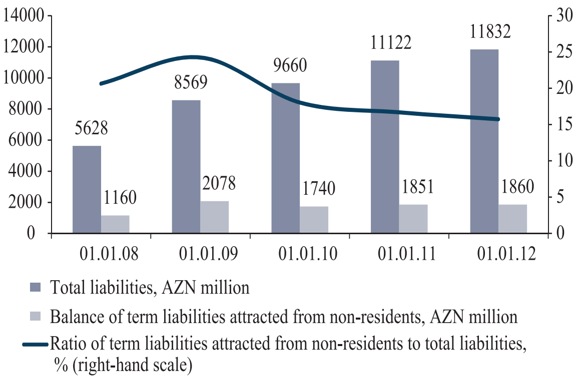
Chart 55. Structure of individual deposits (at year-end), %



Source: CBA

During the year funds attracted from financial institutions (loans, deposits and other resources from other banks and other financial institutions) totaled to AZN3.7 billion (31% of the total bank liabilities) as of January 1, 2012.

Chart 56. Changes of term external borrowings



Source: CBA

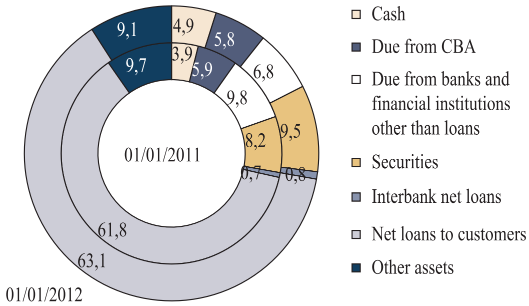
Term funds attracted from non-residents (excluding individual deposits) netted an AZN9.1 million (0.5%) increase. **Term external borrowings** totaled AZN1.86 billion, representing 15.7% of the total bank liabilities. Overall, the external debt of private banks has dropped by 41% (or AZN440 million) to AZN640 million over the past 3 year.

6.3. Structure of the banking system's assets

During the reported year banks continued their financial support of economic activity, and noted some positive structural shifts in assets.

In 2011 the total bank assets increased by AZN968.0 million or 7.3% totaling to AZN14 259.2 million. For comparison, bank assets rose by 5.8% in 2010. Bank loans increased by AZN727 million or 8.1%, reaching AZN9698.8 million as at January 1, 2012. Loans represented 68% of (net) assets.

Chart 57. Structure of bank assets, %



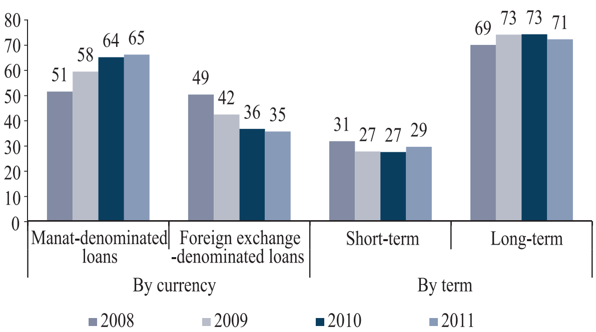
Source: CBA

The growth of the **loan portfolio** is largely attributable to individual deposits and the non-financial corporate sector's deposits.

Long-term loans increased by 4.4% to AZN6834.4 million by the year-end. Long-term loans amounted to 71% of the total loan portfolio by the end of 2011.

The **currency structure of loans** also showed positive changes during the year. The stable exchange rate secured an 8.7% increase of national currency-denominated loans in 2011, thereby ensuring their principal input in the overall loan portfolio growth. National currency-denominated loans represented 65% of the total loan portfolio.

Chart 58. Structure of loans, %



Source: CBA

Loans to households, trade and services represent a substantial portion of the loan portfolio. Construction and real estate sectors (32.5%), trade and services (29.2%), households (21.9%), agriculture and processing industries (5%) showed the highest growth rates in terms of lending.

Loans to households totaled to AZN3085.2 million, which represented 31.8% of the total loan portfolio (28.2% as at 01.01.2011).

Box 9. Growth rate of loans and financial stability

Lending may have both positive and adverse effects on economic growth. For instance, loans contribute to production growth by stimulating consumption and investments, consequently fostering economic growth. However, an excessive credit growth may pose threats to financial stability. The growth rate of loans might stimulate the demand in excess of the potential output gap, which may cause the economy to overheat, give rise to inflation and result in asset price increases. An analysis of excessive credit growth factors in the following:

Type of borrower – in an environment of high economic growth expectations of borrowers' ability to perform are overestimated, wherefore high risk loans are in demand. Hence, it is essential to enhance the monitoring of the borrower's balance sheet in order to measure their ability to repay the loans.

Distribution of borrowers by sectors – banks display greater exposure to macroeconomic shocks and credit risks as the industry-based distribution of credit expands.

Currency type – the borrower's ability to repay loans in foreign currencies diminishes as the national currency depreciates.

Term of loan – borrowers may experience difficulties in repaying large long-term loans.

Security – availability of security greatly reduces the financial institution's risk if the borrower fails to perform.

Best international practices recommend the following measures to prevent excessive credit growth:

To set up a counter-cyclical capital cushion and reserves;

To introduce loan expansion procedures (currency, term, industry, security, etc.);

To reduce fiscal costs;

To establish additional provisions adequate in relation to credit growth;

To ensure oversight of capital flows;

To foster development of financial markets, etc.

Source: Assessing and Managing Rapid Credit Growth and the Role of Supervisory and Prudential Policies, July 2005, IMF

The growth rate of mortgage loans was 43.4% in 2011 and mortgage lending amounted to AZN575.8 million as at 01.01.2012 (mortgage loans amounted to approximately AZN401.4 million or 4.4% of the total loans as of 01.01.2011). Such loans represented 5.9% of the total (bank) loan portfolio as at 01.01.2012.

Investments in securities totaled to AZN1356.4 million as at January 1, 2012, which exceeds the previous year's level by 35.5% or AZN355.4 million. Securities represented 8.8% of the average assets. The securities portfolio experienced certain structural changes. Thus, while corporate securities made up 66.5% (AZN666 million) of the securities portfolio in 2010, this indicator reached 70.8% (AZN959.8 million) in 2011. Investments in government securities increased by 18%, totaling AZN394.6 million by the year-end.

Table 11. Loans by sector

	01.01.2011		01.01.2012		Artım, azalma	
	AZN mil	As percentage of total	AZN mil	As percentage of total	AZN mil	As percentage of total
Trade and services	2201,0	24,5	2843,5	29,3	642,5	29,2
Households	2531,3	28,2	3085,2	31,8	553,9	21,9
Agriculture and processing	435,4	4,9	457,2	4,7	21,8	5
Construction and real estate	660,6	7,4	875,2	9,0	214,6	32,5
Industry and production	682,3	7,6	582,9	6,0	-99,4	-14,6
Transport and communications	454,4	5,1	409,7	4,2	-44,7	-9,8
Other	2006,8	22,3	1445,1	15	-561,7	-27,9

Source: CBA

Box 10. The LTV ratio

The loan to value ratio (the LTV ratio) is one of the ratios used by banks in credit risk assessment before granting a real estate loan. A high ratio typically indicates a high risk, therefore, the loan decision includes a higher interest rate and the borrower acquires mortgage insurance.

The LTV ratio represents the percentage of the principal amount of the loan with respect to the asset it is secured with. For example, if an AZN100 000 loan is secured with an AZN150 000 asset, the LTV is 150% (100 000/150 000).

Like other ratios used in credit risk assessment, the LTV ratio is not the only criterion factored in the overall real estate loan assessment.

The LTV ratio has the following effects on the system:

1. Growth rate of loans
2. Minimization of default probability
3. Stabilization of real estate market prices

As an effort to preserve the financial stability, the Central Bank of Azerbaijan increased the real estate security requirement from 120% to 150% on April 30, 2008.

Source: Macro prudential instruments and frameworks: a stocktaking of issues and experiences, BIS, May 2010

6.4. Capital of the banking sector

Banks moved further along the path of strengthening their equity, keeping the banking system's overall capital adequacy ratio satisfactory in 2011.

The total bank capital increased by 12.7% (or AZN241.6 million) to AZN2138.7 million in 2011. In general, **Tier I capital** drove the increase in the total bank capital. Tier I capital increased by AZN206 million (13.6%) to AZN1726.8 million.

The banking system maintained a high level of total **capital adequacy** (16.3%), substantively higher than the Central Bank's minimum requirement (12%) and the internationally accepted minimum (8%). The Tier I capital adequacy was also two times as much as the required minimum (13.1%).

Table 12. Structure and development path of the banking sector's total capital, AZN mil

	01.01.2011	01.01.2012
Tier I capital	**1 520,5**	**1726,8**
Change year-to-date, %	*18,3*	*13,6*
Paid-in capital	1359,4	1556,9
Surplus	20,7	20,7
Net retained earnings	169,2	185,7
Tier II capital	**440,1**	**494,9**
Profits from the current year	165,8	187,6
General reserves	139,8	163,4
Other capital funds	134,4	151,5
Deductions from total capital	63,4	83,0
Total capital after deductions	**1 897,1**	**2138,7**
Change year-to-date, %	*7,9*	*12,7*

Source: CBA

Box 11. Leverage ratio

In 2009, the Basel Committee recommended incorporating the leverage ratio in the set of capital adequacy ratios. The purpose of using the leverage ratio is to assess the capital level, balance the growth rates of the banking system's assets and capital, limit excess borrowings in the banking system, ensure stability of the banking system, promote sound and safe growth of bank assets. In consideration of the Basel Committee's recommendations, the Central Bank of Azerbaijan chose to apply the leverage ratio starting from the current year, setting the minimum for the ratio at 8%. The Central Bank's "Capital Adequacy for Banks" regulation suggests the following formulae for the leverage ratio:

$$\text{Leverage ratio} = \frac{\text{Tier I capital}}{\text{Balance sheet assets + Off-balance sheet liabilities}} * 100\%$$

Source: CBA's "Capital Adequacy for Banks" regulation and Basel III: A global regulatory framework for more resilient banks and banking systems, BIS, revision June 2011

6.5. Financial performance of the banking sector

Overall, the banking system's financial performance was satisfactory in 2011.

Profits earned by banks in 2011, before taxes, totaled AZN160.8 million, while net profits after taxes increased by 17.5% totaling to AZN141.4 million.

71% of banks completed the year of 2011 with profits of AZN187.6 million, while 30% of banks with losses of AZN46.3 million. Banks that completed the year with losses accounted for 20% of the total bank assets.

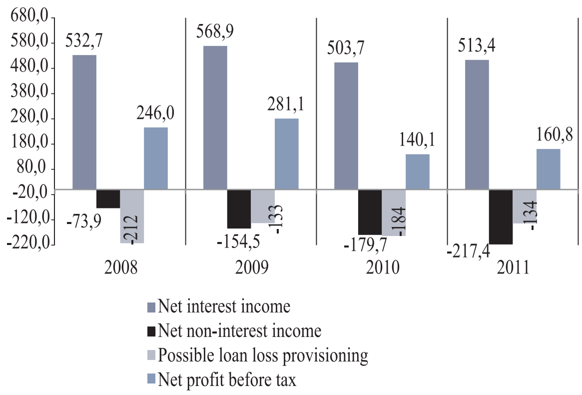
During the year **interest income** totaled to AZN1099.8 million having increased by 4% (with interest income on loans to customers increasing by 7% to AZN1011.6 million) against the previous year. Total income of banks amounted to AZN1420.8 million, which exceeds the 2010 level by AZN93.8 million or 71%. Total interest income represented 77.4% of the total income in 2011.

Interest expenses totaled to AZN586.3 mil by the year-end having increased by 6.3% against the previous year. Despite the growth of the interest expenses in absolute terms, the ratio of such expenses to average assets decreased from 4.6% of 2010 to 4.5%.

Net interest profit of banks totaled to AZN513.4 million in 2011, which exceeds the 2010 level by AZN9.7 million or 1.9%.

Non-interest expenses of banks increased by 19.3% against the previous year, totaling to AZN538.4 million. Total non-interest expenses rose from 3.7% to 4.1% as a percentage of average assets, primarily due to the growth of salary, remuneration and other operating costs.

Chart 59. Structure of profits, AZN million



Source: CBA

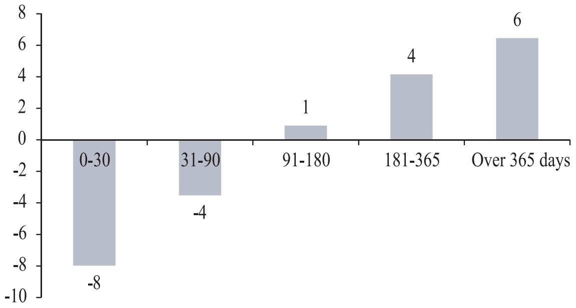
Return on assets of the banking sector (calculated as a ratio of net profits before taxes to average assets, ROA) made 1.1% in 2011, while return on equity (calculated as a ratio of net profits before taxes to average equity, ROE) amounted to 7.8%.

6.6. Risks of the banking sector

The banking system preserved its financial stability and minimized its risks in 2011.

In 2011, the banking system maintained a **level of liquidity** sufficient to honor its obligations to creditors and borrowers on time. Improvements in the structure of the banking system's deposit base made a positive contribution to the strengthening of the liquidity position.

Chart 60. Maturity mismatch of assets and liabilities (as percentage of assets, %)

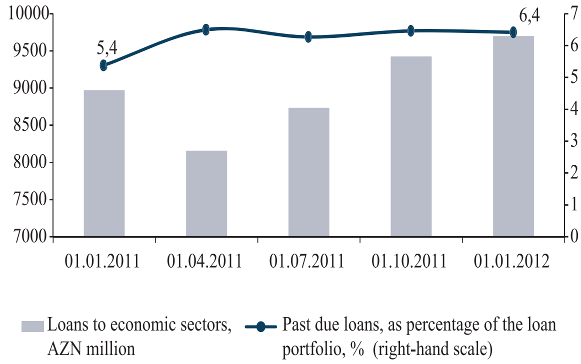


Source: CBA

Increased their loan underwriting requirements coupled with the growth of domestic and more stable liabilities of banks ensured a more sustainable liquidity position. The high liquidity position allowed for reducing the cost of funds and improving the real sector's access to financial services. This, in turn, enables the banks to build their financial strength on a sound foundation.

With lending expanded liquid assets ranged from 14 to 19% of the total assets during the year. As banks **optimized the maturity structure of**, and minimized the maturity mismatches between assets and liabilities, the banking system benefited from reduced liquidity risks. A liquidity gap analysis also indicates an acceptable level of liquidity (ratio to assets in the range of -8%-+6% as at 01.01.2012).

Chart 61. Characteristics of loans to economic sectors and past due loans



Source: CBA

Box 12. Debt burden of households and transmission

Households are instrumental in securing financial stability through distribution of resources, especially deposit recovery and spending patterns. For instance, households ensure return of their funds by investing in bank deposits, securities, real estate and other assets; they also finance consumption by borrowing from financial and non-financial institutions.

Households are affected through the following transmission channels.

Interest rate channel. When the central bank reduces the interest rates, individuals tend to borrow more in order to invest in non-interest bearing assets and thereby contribute to consumption growth.

Credit channel. As a result of the stringent monetary policy banks increase their interest rates thereby limiting individuals' access to credit.

Currency exchange rate channel. With depreciation of the currency exchange rate domestic goods fall below imported goods in terms of cost, which stimulates domestic demand. However, depreciation of the currency exchange rate leads to an increase of households' foreign exchange-denominated debt burden.

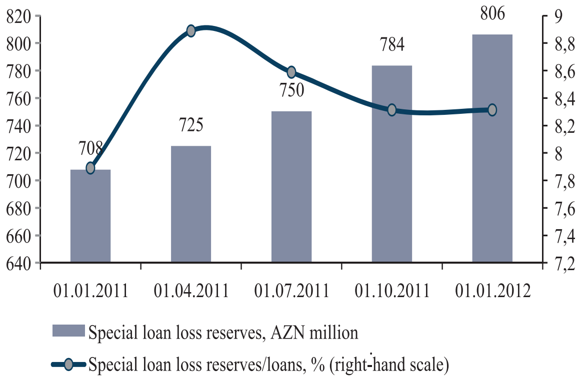
Funds channel. As the price of their assets rises households find themselves in possession of security of greater value, which stimulates increased borrowing.

Borrowing increasingly enables households to tackle consumption costs. It facilitates real estate purchases, while promoting additional income sources for financial institutions and enabling environment for diversification of the banking sector's portfolio. However, increased debt burden of households adds on to the economy's crisis and instability sensitivity.

Source: "Household debt: implications for monetary policy and financial stability", May 2009, BIS

Past due loans amounted to 6.4%, sub-standard loans for 8.5% of the total loan portfolio at the year-end.

Chart 62. Loan provisioning



Source: CBA

The **loan loss reserves** amounted to 8.3% of the loan portfolio as of January 1, 2012 (7.9% as of 01.01.2010).

6.7. Bank supervision

The supervisory function's regulatory and oversight efforts in 2011 aimed at ensuring an optimal balance of growth and sustainability, minimizing systemic risks, securing stable performance of the sector and maintaining public and investor confidence. Furthermore, the bank supervision function also sought to properly address the post-crisis challenges and harmonize with the global regulatory framework, as well as tackle the banking sector's current problems.

The **supervisory function moved further along with adaptation to global challenges** in 2011, enhancing its early warning capacities. A new ratio (the leverage ratio) was introduced to measure capital adequacy, as part of the CBA's overall efforts to improve the quality of bank capital and ensure a sustainable growth of bank assets. Furthermore, the function thoroughly studied the

Box 13. Stress-testing experiences of central banks

The ever increasing focus on the sustainability of individual financial institutions and the system as a whole in the aftermath of the latest financial crisis has necessitated an expanded scope of application of stress-tests. The Effective Stress-Testing and Supervision Principles developed by the Basel Committee provides for preparation of quality stress-testing methods for banks. These principles require central banks to incorporate the findings of stress-test exercises carried out by individual banks into their own stress tests (the bottom up approach). However, in reality not all credit institutions are capable of conducting quality stress-tests. As a result, when central banks build their own models (the top-down approach), their stress-testing exercises measure the losses arising as a result of realized credit risks, revocation of attracted funds and market risks (currency, stock and interest rate risks) by applying 'shock factors' (identifies the losses incurred by the entire banking system by adding up all losses) to each bank's balance sheet indicators. In addition, the model also takes account of the impact of interbank loans on the banking system's sustainability (the domino effect).

Stress-testing methods are refined by introducing new macroeconomic indicators and employing new statistical methods and econometric models with various levels of complexity. The next step of these methods is the evaluation of the interconnection between macroeconomic indicators and the banking sector's lead indicators. For instance, some European central banks stress test the banking sector by using macroeconomic factors included in the respective country's macroeconomic model (Italy, Germany, France, Sweden, Austria, the Netherlands) or a set of equations that links the quality characteristics of banking risks with macro-indicators (England, Austria). In general, the Value-at-Risk and Vector Error Correction Model approaches are widely used to assess banking risks. Banking risks are assessed from the loan portfolio angle for the banking system as a whole (Austria) or across economic sectors (Italy).

Considering recent publications on stress-testing, it should be safe to presume that banks are more inclined to use models that employ macroeconomic stress-factors and have interconnections.

Source: 1.Principles for sound stress testing practices and supervision. Basel Committee on Banking Supervision. 2009.

prospects of introducing the "conservative buffer", which is instrumental in providing sound and safe performance of the banking system, funding capital from more stable sources (increasing the share of Tier I capital in the total capital), and new liquidity requirements as advised under the Basel III standards for improved management of bank liquidity.

The **Central Bank implemented structural adjustments** in order to complete the formation of a set of macro-prudential supervisory tools and further enhance the relevant internal capacities. A new unit was established and staffed, responsible for financial stability and prudential policy. The supervisory function's internal human and technical capacities were strengthened. As a result, the Bank's regulatory and supervisory functions were segregated, while 'multi-tier' internal management processes were formed rooted in corporate governance and risk management principles.

The **intensive bank supervision environment** was optimized, largely in order to adequately evaluate risks and thereby properly estimate financial sustainability as well as capital adequacy. Financial soundness indicators of banks were intensively monitored; findings of regular stress-tests were used to support proactive management of financial stability.

In the reported year the **Central Bank** took a number of measures to prevent **banks from engaging in pro-cyclical conduct**. Taking account of recommendations ensuing from the G20 summit, the Basel Committee and European Bank Supervisors Commission's advisements, the Central Bank of Azerbaijan drafted a Regulation for Compensation Systems for Banks, which sets forth minimum requirements with respect to banks' compensation policies. The Regulation will be put in place in order to help banks set up a compensatory system in consistency with their strategic goals, risk profiles, performance specifics and complexities. Furthermore, draft Bank Regulation for Stress-Testing was developed, which identifies the stress-testing requirements for measuring the ability of the banking system as a whole and individual banks to resist and control various internal and external influences.

Requirements were enhanced with **respect to the internal management capacities and systems of banks** and a new risk management philosophy was developed in 2011. A new regulation has taken effect, which will address the development of effective risk management controls in banks. The Central Bank developed and initiated in systemic banks a new assessment system to measure the level, operability and adequacy of banks' risk management systems. This approach will allow assessing banks in terms of development levels on an indicative basis.

Under the arrangement entered into by Government of Azerbaijan, the World Bank and the International Monetary Fund in the reported year, a Road Map was developed with an aim to prepare for the implementation of the **Financial Sector Assessment Program** (FSAP) in Azerbaijan in 2012. In this connection, areas of the Central Bank's functional competencies were assessed, including an evaluation of the bank supervision function's compliance with the core principles of the Basel Committee for Effective Banking Supervision; deficiencies thus identified were examined and a special action plan was put in place to eradicate these flaws.

The year of 2011 saw continued efforts conceived to increase the effectiveness and improve **protection of banking services consumers' rights** and the transparency thereof. The Group for Protection of Banking Services Consumers' Rights proceeded as a department, treating the Central Bank's hotline requests and claims within the scope of its competence. In addition, the Central Bank initiated a system for electronic filing of consumer claims. Furthermore, efforts were continued under the Financial Services Development Project supported by the World Bank and SECO, Switzerland, aimed at protecting the rights and increasing financial awareness of financial services consumers.

The Central Bank carried on with improvements of supervisory processes with **respect to non-bank credit institutions** and introduced new supervisory tools. In this view, the Central Bank trained the administrators of non-credit institutions in new regulatory procedures during the year. Furthermore, procedures for NCI reporting to the Central Bank were updated to consistency with the new regulations; the new reporting procedures were

Box 14. Assessment of the impact of macro prudential tools by Taylor's rule

In its October 2009 issue of 'International Economic Prospects', the International Monetary Fund (IMF) recommends a broader use of *macro prudential tools* for controlling macro-financial risks. These tools (*macro-prudential*) are specifically pointed out as extremely critical for ensuring stable inflation and economic growth when financial assets are subjected to price shocks. The publication contains an econometric measurement of the significance of macro-prudential policy using Taylor's rule. The measurement includes an examination of the following regimes:

1. Standard Taylor's rule

2. Extended Taylor's rule – scope of credit (lending) also affects the refinancing rate in addition to the output gap and inflation

3. Macro-prudential rule – scope of credit (lending) has a deferred (lagging) effect on the macro-prudential tool (alteration of the spread between credit and the refinancing rate).

The measurement indicates that macro-prudential policy is evidently instrumental in controlling financial shocks. Furthermore, the measurement also reveals that the macro-prudential tool surpasses the increase of the Central Bank's refinancing rate in terms of significance as far as improvement of lending standards is concerned.

As the table above shows, Taylor's rule has a more advanced position (ranking) under the 3rd regime, which provides yet another case to the point of macro-prudential tools playing a key role in securing macro-economic stability.

Measurement under various regimes

Regimes[xx]	Inflation rate (standard deviation)	Output gap (standard deviation)	Loss[x]	Ranking
Standard Taylor	0.512	0.624	0.652	4
Extended Taylor	0.110	0.076	0.018	3
Extended Taylor+macro-prudential	0.092	0.061	0.012	2
Optimal weighted extended Taylor+macro-prudential	0.018	0.040	0.002	1

[x] *Sum of output gap and inflation variations*

[xx] *Interest rate percentage is set at 0.7, other indicators are set at 0.3.*

Source: Lessons for Monetary Policy from Asset Price Fluctuations World Economic Outlook. – IMF, October 2009

test-run during the year. In addition, risk-based individual supervision was introduced, ensuring increased reporting frequency for individual credit institutions, as necessary, and monitoring procedures put in place.

The Central Bank prioritized the **formation of a risk-based prudential supervision framework** compliant with best international practices as a strategic goal defined under the 2011-2014 Strategic Plan. Pursuant to the Strategic Plan, a new methodology of Risk-Based Supervision Framework was drafted in 2011, which identifies the banking supervision system's architecture, scope, core business processes and hierarchy of positions and competencies.

VII. BANKING LAWS

The Central Bank's drafting efforts in 2011 principally centered on conceiving a legal framework that would facilitate preventive and supporting measures aimed at precluding the recent global financial crisis from adversely affecting macroeconomic stability and the financial and banking system.

A number of draft banking legal and regulatory documents were developed and submitted to the relevant government authorities under the Financial Sector Assessment Program (FSAP). For instance, in accordance with the recommendations of the Basel Committee for Effective Banking Supervision, proposals were made to incorporate in the relevant law's provisions to enable the Central Bank to engage external specialists in bank inspections on as-needed basis, and provisions concerning fit-and-proper requirements with respect to bank administrators and a variety of other issues.

European Directives were examined to identify the principal inconsistencies of Azerbaijan's banking laws with the directives. In connection with the negotiations for signing the Association Agreement between the Republic of Azerbaijan and the European Commission, the European Directives were thoroughly examined in order to identify any major inconsistencies of Azerbaijan's banking laws with the said directives and a process was initiated to address the inconsistencies thus revealed.

Studies indicate that legal problems and institutional deficiencies associated with mortgage security constituted a major contributor to the increased share of past due loans in the banks' total loan portfolio against the backdrop of the global financial crisis. For instance, the difficulties faced by creditors when registering and exercising security interests in mortgages often hinder a lawful and effective execution of the entire mortgage process. In this view, the Central Bank developed and discussed with the banking community and competent government authorities a range of legal proposals; subsequently, draft amendments to a number of existing laws and regulations were submitted to the legislative initiative authority, including the Civil Code of Azerbaijan Republic and the Law on Mortgage of Azerbaijan Republic. Technical assistance of the International Financial Corporation (IFC) was used in the drafting of the amendments.

In addition, pursuant to Presidential decrees and resolutions, a set of proposals was developed and submitted to relevant instances, regarding the legal and regulatory documents governing the national's mortgage lending system in order to improve the country's mortgage lending mechanisms and accelerate refinancing processes; Azerbaijan Mortgage Fund's internal policies were amended.

Works were continued to upgrade the Law on Credit Unions in order to provide appropriate support to the country's micro-financial businesses and reinforce this particular sector's financial discipline; the consultant engaged with the support from the World Bank and Azerbaijan Credit Union Association (ACUA) submitted his inception report for discussions.

The discussions covered a variety of issues such as the organizational and legal form, reinforcement of the capital base, self-control systems and other prudential matters that may have a positive impact on the credit unions' capabilities to lend to their members and enhance the transparency of their operations. Changes proposed in the course of discussions focused on implementation of cooperative management structures in credit unions in compliance with international standards (WOCCU), transition to non-profit orientation of business, development of special supervisory models to regulate such institutions, etc.

The draft Law on Agricultural Cooperatives adopted by the Parliament of Azerbaijan Republic on April 15, 2011 in the first reading identifies agricultural credit cooperatives as a kind of consumer cooperatives. The Central Bank shared its opinion and assessment of the draft law. Discussions will be continued on this subject with the legislative and relevant executive authorities and specific legislative proposals will be made in the next year.

The Constitutional Law on Regulatory Documents of Azerbaijan Republic, which took effect on February 17, 2011, sets forth new regulation-making responsibilities of government authorities, including the Central Bank, with regards to drafting, expert assessment, adoption, etc., of regulatory and legal documents. Pursuant to the Presidential Decree affecting the Constitutional Law, the Cabinet of Ministers issued the Resolution No.184 of November 11, 2011, approving the Policy for Development and Adoption of Regulatory Documents by the Central Bank of Azerbaijan Republic.

Considering the ensuing need to harmonize the existing banking laws with the Constitutional Law and Civil Code amendments, proposals were developed jointly with the Ministry of Justice of Azerbaijan Republic and submitted to relevant instances. In parallel, the Central Bank continued to work on proposals concerning harmonization of its regulatory documents with the above mentioned regulatory and legal documents. These efforts will be continued in 2012 as well.

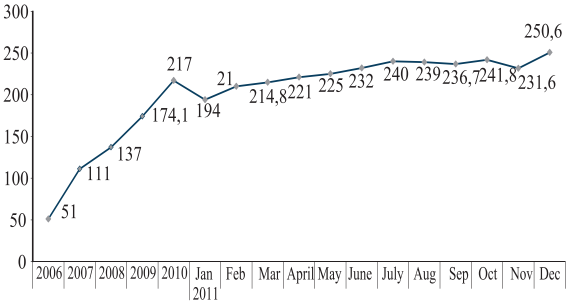
VIII. MORTGAGE LENDING

Continuing mortgage lending played a key role in improving consumers' housing conditions and supporting economic activity in 2011.

A total of AZN96 million of mortgage loans was channeled through authorized credit institutions to approximately 2600 individuals in 2011. Thereby, the Azerbaijan Mortgage Fund (AMF) counted AZN345.6 million worth of 8800 **mortgage loans** it had financed by the end of 2011. The AMF continued to offer secured bonds in 2011, generating AZN77 million (2031 mortgage loans) from domestic market during the year. Thus, the Fund's refinanced loan portfolio totaled to AZN253 million.

Given the changes in Azerbaijan's real estate market and the terms of mortgage lending in 2011, the **mortgage affordability index** rose from 194% to 250%.

Chart 63. Mortgage-based housing affordability index in Azerbaijan, %

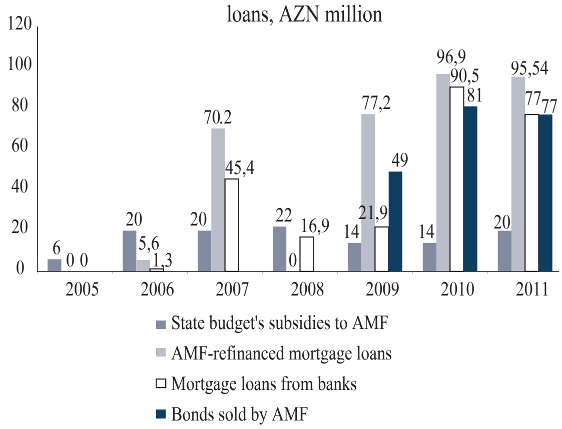


Source: CBA

During the year, a total of AZN16.7 million of **discounted mortgage loans** (4% per annum) were granted to special categories such as young families (members of Martyr and National Heroes' families, internally displaced persons, public servants, candidates of sciences or doctors of sciences, decorated/honorary accomplished masters of sports) and military servants, in continuation of the government's social policy. Thus, the state budget's subsidies made over the past six year for mortgage loan refinancing totaled to AZN116 million.

The AMF, which had become an active player

Chart 64. Changes of financial resources by mortgage loans, AZN million



Source: CBA

at the financial market, managed to raise AZN207 million worth of free market funds in 2009-2011. The AMF intends to continue using free funds in 2012 as well in order to ensure that mortgage lending proceeds in a consistent and undisrupted manner.

The AMF maintained its positive **international rating** in the reported year. Fitch Ratings evaluated the AMF's performance in October 2011 and upgraded the AMF's rating projection from 'Sustainable' to 'Positive', while keeping the original BBB- credit rating of the Fund's local and foreign exchange-denominated long-term liabilities at the relevant investment grade level.

The primary financing mechanism used to facilitate timely channeling of budgetary assignments to borrowers was improved during the year. Durations and interest rates of primary financing operations were revised.

The Central Bank made **amendments** to the **Standard Requirements** for mortgage loan refinancing (assessment of creditworthiness, verification of income, performance of insurance obligations, oversight by authorized banks). Furthermore, partnership arrangements were made with authorized insurance companies for online payment of insurance fees.

The AMF initiated the **Electronic Mortgage** project in 2011, designed to complete automation of lending and refinancing processes, reduce paperwork between market actors and the AMF, keep track of mortgage loan requirements in real time, establish a priority line for application review and enhance transparency of business processes.

IX. CENTRALIZED CREDIT REGISTRY

Along the lines of its mission statement, the Centralized Credit Registry (CCR) collected detailed credit information on individuals and legal entities with outstanding credit liabilities to banks in parallel to enabling users to make online inquiries.

The Centralized Credit Registry introduced a number of important arrangements during the year, including **accession of non-bank credit institutions to the CCR system**. 18 NBCI's out of the total of 26 institutions operating in the country that presented their information in the required format and Agrar Credit JSC completed their connection to the registry starting from August through the end of the year. As relatively larger micro-financial institutions equipped a better information technology infrastructure completed their technical preparations the credit registry covered 90% of the NBCI's year-end loan portfolio. A testing platform was set up and put in operation, which is designed to complete the technical preparations of the other NBCI's. The credit registry connection of NBCI's was facilitated by the newly adopted Law on Non-Bank Credit Institutions and recent amendments to the CCR Regulation during the year.

A new version of the CCR software was implemented in 2011. The upgraded version provides the system with analytical data verification tools in addition to lifting the number of users' limitations. The CCR introduced electronic certificates issued by the Central Bank's Certification Center for the first time. Certificates prepared individually for each user are used as means of unambiguous identification of connected users as well as appropriate safeguards for the system.

A procedural innovation was made in the system in 2011, which requires authorized system users to personally sign off for responsibility for dissemination of any data that they get a hold of through the use of the system. Another modification of the system's settings was the requirement to obtain a written consent from the individual being queried about when inquiries are made regarding prospective borrowers. These arrangements that are broadly used internationally provided a great input to enhancing the security of personal information, as well as enabled the system to form individual inquiry records to be incorporated in credit reports.

The charge for individual inquiries was eliminated on February 1, 2011 with an aim to improving protection of consumer rights and facilitate their unimpeded access to their own credit records. Furthermore, a distant query procedure was introduced to improve access of regional residents to such data.

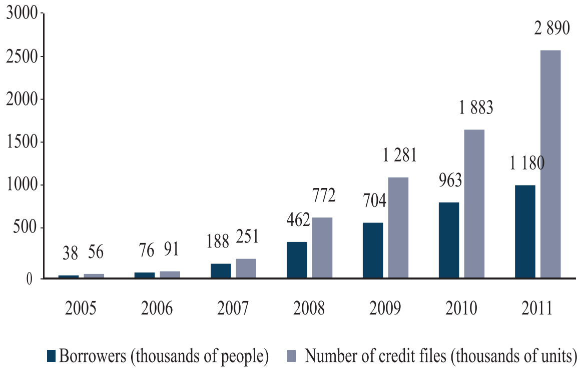
Technical upgrades were made during the year to provide direct access to the registry for bank and NBCI branch offices, as requested by banks/NBCI's. 14 banks completed this process during the year, whereby 201 branch offices, beside their respective head offices, are now equipped appropriately to make direct real time inquiries to the registry's system. The system's user count reached 430 in the reported year. On top of that, regional offices as well as retail sales offices of banks and NBCI's were enabled to set up mobile credit desks and fast-track the relevant decision-making process.

A renewed CCR credit report was introduced in 2011. The report is much more simple, readable and reliable and carries a greater load of information. The credit report has been expanded to incorporate the borrower's performance quality details in addition to regular liability information; it now also contains data on obligations with the borrower's backing. Furthermore, the credit registry now keeps record of group credit liabilities realized by more NBCI's, while the credit report has been upgraded to incorporate the concerned individual's relevant obligations.

With an aim to ensuring borrower identification using a single code, an interface was established linking the registry with the Interagency Automated Data Search System (IADSS), the country's centralized electronic database of identification card details, which allows for unique identification of individuals. The interface enables the system to identify individuals registered under different documents using single/uniform codes as well as to reduce the query time to a few seconds.

Print **training materials** and handouts were prepared and disseminated to users in order to facilitate the use of the system by banks and NBCI's.

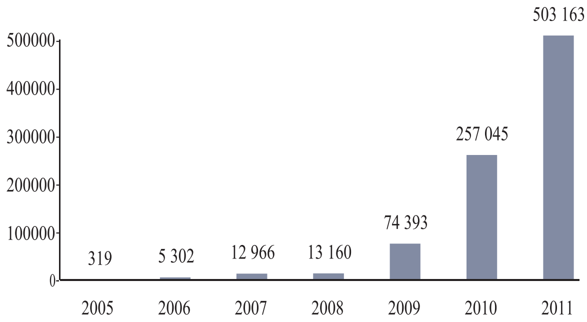
Chart 65. Changes of the CCR's data flows



Source: CBA

The Central Bank continued to collaborate with the International Financial Corporation (IFC) under the Azerbaijan and Central Asia Financial Infrastructure Improvement Advisory Services Project with an aim to develop a legal framework governing credit bureaus and to support establishment of private credit bureaus in Azerbaijan.

Chart 66. Number of queries



Source: CBA

At the year-end, the CCR counted 1 179 711 borrowers, 2 890 334 credit files and 411 688 guarantors. 42 banks and 10 NBCI's used the registry during the year. The CCR processed 503 163 inquiries during the reported period, which is 1.96 times more than the previous year's level; (257 045 in 2010). 1494 individuals made inquiries during the reported period (298 in 2010).

X. PAYMENT SYSTEMS

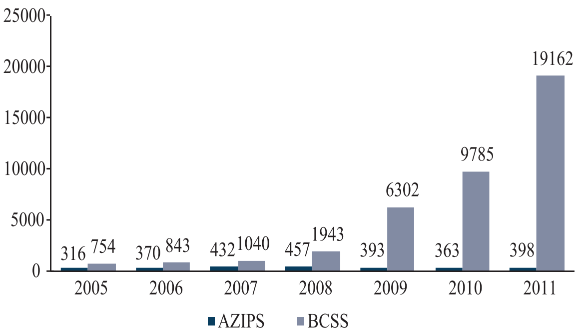
10.1. Stable and reliable operation of payment systems

Alongside other priority tasks for 2011, the Central Bank focused on ensuring sound and reliable operation of the payment systems, upgrading the electronic payment services by enhancing their infrastructural capacities in accordance with best international practices and promoting effective use of such capacities.

Interbank settlement systems, the core components of the National Payment System established and managed by the Central Bank, continued to operate in consistency with their performance criteria.

Azerbaijan Interbank Settlement System **(AZIPS)**, one of the core components of the overall payment system, processed AZN99279 million worth of 398 thousand payment documents, which exceeds the previous year's level by 26.6% (AZN20854 million) and 9.6% (35 thousand documents) accordingly. The system's average daily document load counted 1600 payment documents, with each one at AZN249 thousand.

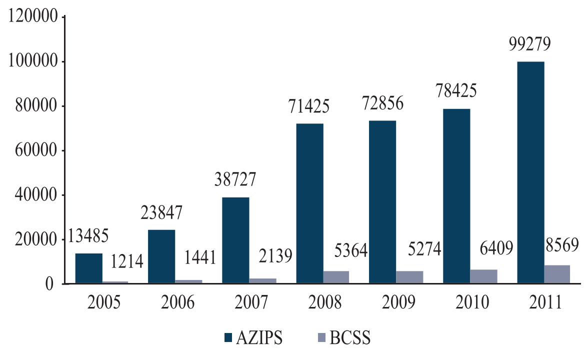
Chart 67. Number of payment documents in AZIPS and BCSS systems (thousands of pcs.)



Source: CBA

The National Payment System's other major component, the Bulk Clearning and Settlement System (BCSS), processed a total of 19162 thousand payment documents for a total worth of AZN8569 million, which exceeds the previous year's level by 95.8% (9377 thousand documents) and 33.7% (AZN2160 million) correspondingly. On a daily basis the system processed on average 79.1 thousand documents, where each document amounted to AZN447 on average.

Chart 68. Total payments in AZIPS and BCSS systems, AZN million



Source: CBA

AZIPS had a 2% and BCSS a 98% share of the total number of payment documents in 2011, while AZIPS accounted for 92% of the total payments, with BCSS closing at 8%.

10.2. Development of the National Payment System

The functionalities and scope of use of the electronic payment systems were greatly enhanced as a result of the measures taken in the reported year.

The **Centralized Information System on Mass Payments (CISMP)** established and commissioned by the Central Bank in 2008 in order to support the utility sector reform, and increase the rate of collections and transparency in collecting of utility bills using a uniform electronic payment system as well as to move the cash flows in this field to the banking sector, advanced on its regional coverage by taking over on the operational areas of the country's major network utilities.

Consequent to the integration of all of the country's card processing centers with CISMP, these centers have been enabled to offer their client banks the functionality of ATM and online payments for their customers.

In execution of the Presidential Decree of February 14, 2011 on a Set of Measures Designed to Enhance the Social Security of Traffic Patrol Officers of the Ministry of Internal Affairs of Azerbaijan Republic and Traffic Control, **stipulating payment of traffic tickets and fines exclusively by means of bank transfers or plastic card charges**, the Chief State Traffic Police Administration of the Ministry of Internal Affairs also integrated with CISMP. The system has been uploaded with details on over 1.5 million driver's licenses. Payers are now able to view traffic fine data and make payments at CISMP-connected payment offices as well as through the system's web-site (www.apus.az).

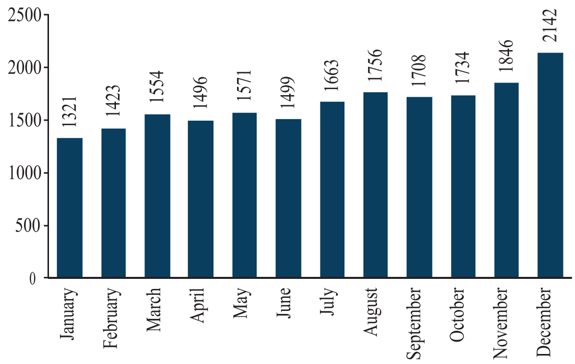
Pursuant to Presidential decrees concerning migration of tax, duty, rental and other payments and charges to real time electronic settings, the scope of CISMP functionalities and capacities was expanded as the Government Payment Portal was devised and put in place. As an inception of the **Government Payment Portal's** operation, the Ministry of Taxes made a pilot connection to perform first payments in late 2011. Using the new functionality, a taxpayer entered a personal virtual office at the Electronic Tax Department via the Internet, and made a payment of his choice using a payment card via the payment system infrastructure. The test run successfully completed automated identification of payment details via the centralized budget account and direct processing of the payment via the State Treasury Agency's internal system.

Chart 69. Total payments in CISMP, AZN thousand

Source: CBA

As of January 1, 2012, CISMP counted 42 collection financial institutions, and 1200 payment offices of banks and Azerpost LLC covering Baku and rural areas. The system processed 19.7 million transactions for a total worth of approximately AZN328 million in 2011. The system's average daily document load amounted to 63.2 thousand units.

Chart 70. Number of payments via CISMP (thousands of units)



Source: CBA

AZERPOST Limited Liability Company (LLC) increased the number of post offices providing financial services in 2011. Thus, the Central Bank granted financial services licenses to 4 branch offices and 274 post offices of Azerpost LLC in the reported year. As of January 1, 2012, Azerpost LLC counts 63 branch offices (57 in regions) and 867 divisions (764 in regions). Furthermore, 618 branch offices and divisions of the enterprise (488 in regions) have integrated with the Bulk Payment Centralized Information System established by the Central Bank.

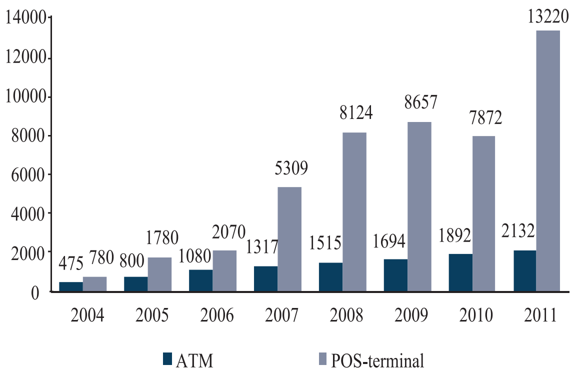
Current accounts of all of Azerpost's branch offices with other banks were closed and a single correspondent account was established at the Central Bank. In addition, Azerpost LLC set up domestic and foreign correspondent accounts as a means of facilitating domestic and international payments. The National Postal Operator launched local card transactioning under the card services agreement signed with MilliKart LLC.

Azerpost LLC continued networking and connecting the head offices of its regional branch offices to the Automated Corporate Information System (ACIS) in 2011. Presently, a majority of post offices of the Baku and Ganja branch offices as well as 615 post offices of 60 branch offices employ the account-free money transfer and agency services module and the mailing and international postal money transfer services modules of ACIS.

The number of **POS-terminals** amounted to 13220 as of January 1, 2012, of which 12153 are located in Baku and 1067 in regions. AZN388.5 million worth of 1.8 million transactions were executed via POS-terminals in 2011, of which AZN107.7 million is non-cash payments.

The number of **ATM's** increased by 12.7% (240 units) to 2132 units in 2011; the number of transactions via ATM's increased by 6.5%

Chart 71. Number of ATM's and POS-terminals installed, units



Source: CBA

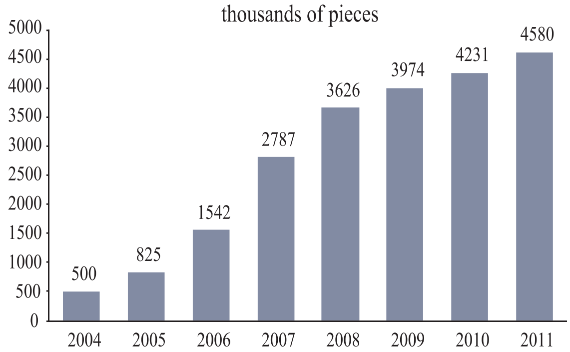
(2827 thousand) to 46.5 million; the amount of transactions increased by 19.3% (AZN1033 million) to AZN6387 million.

During the year, the number of banks issuing **payment cards** reached 40, the number of cardholders – 4.35 million people, the number of cards – 4.58 million pieces, of which 4.4 million are debit and 180.7 thousand are credit cards.

Visa cards accounted for 78%, MasterCards for 20% and other cards for 2% of the payment cards in circulation.

Activities were continued as scheduled under the Action Plan for the banking system's transition to uniform customer account structure (IBAN) in accordance with international standards. Real

Chart 72. Number of payment cards in circulation, thousands of pieces



Source: CBA

time implementation of the IBAN structure in the existing bank accounts will be initiated in 2012.

Visa Inc., designed and implemented the **National Net Settlement Service** (NNSS), commissioned on April 8, 2011, which is designed to help eliminate currency conversion costs and speed up settlements as all settlements executed in the country are denominated in the national currency.

Pursuant to Presidential Decree No.536 of November 24, 2011 on Enforcement of the Law of Azerbaijan Republic on **Protection of Consumer Rights**, behesting that criteria be determined which will be used in identifying facilities where POS-terminals will be installed and procedures and schedules be developed for phased-in proliferation of POS-terminals across the country's regions, a Working Group was established composed of employees of the Central Bank and other relevant government agencies, which prepared and submitted for the government's review a set of proposals to this effect.

The Central Bank set out to draft the Law **on Payment Systems and Services,** which is meant to help introduce innovative payment tools at a broader scale, provide proper oversight of new service providers and fill in the existing legislative gaps.

The 2012-2016 State Program for Expansion of the Scope of State-of-the-art Electronic Payment Services in Azerbaijan Republic has been drafted, which contains a set of integrated measures aimed at developing an electronic payment environment, which will cover the entire country, making non-cash payment tools a common thing used in everyday life, and promoting active use of electronic payment services by all businesses and large groups of population.

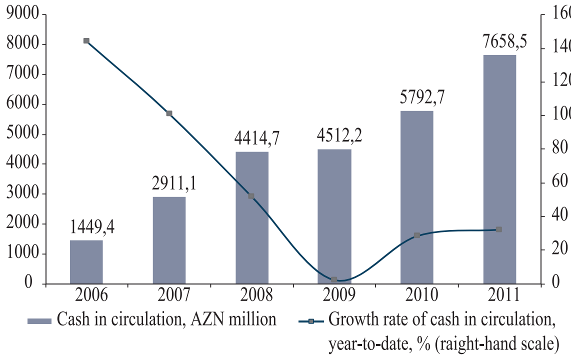
XI. CASH CIRCULATION

11.1. Addressing the economy's cash requirements

In the reported year the Central Bank addressed the national economy's cash demand in full and on time, while forming up strategic reserves of bank notes and coins.

At January 1, 2012, the cash in circulation increased (including cash outside the banking system and in bank vaults) by 32.3% (AZN1.87 billion) to AZN7.65 billion, while in terms of units it increased by 16.1% (50.1 million units) year-to-date during 2011 thus reaching 360.7 million units.

Chart 73. Changes of cash in circulation in 2006-2011 (year-end)



Source: CBA

Cash in circulation broke down as follows in 2011: 99.6% - bank notes, 0.4% metal coins in terms of amounts, and 50.8% - bank notes and 49.2% - metal coins in terms of number of units. Bank notes in circulation increased by 32.3% or AZN1.86 billion year-to-date thus reaching AZN7618.1 million, and by 15.9% or 25.2 mil units in terms of number of units to 183.2 million units. Coins rose by 18.2% or AZN4.5 million to AZN29.2 million, and by 16,3% or 24.9 million units to 177.5 million units.

The most used bank note in circulation during 2011 was the 100 Manat denomination (69.9% or AZN5349.7 million) in terms of amount and units, while among coins the most used denomination was 50 copecks in terms of amount (AZN11.7 million), with the 20 copeck (56.4 million) and 10 copeck (45.9 million) denominations counting the highest in terms of units.

The average nominal weight of bank notes and coins in circulation increased against the previous year. The average nominal weight per bank note made AZN41.6, while for coins in made 16.5 copecks, which indicates that the 20, 50 and 100 denominations of bank notes and 10 and 20 copecks of coins were the most used denominations in circulation.

In the reported year the Central Bank introduced AZN7.0 billion worth of 276.5 million units of money, while withdrawing AZN8.9 billion worth of 326.6 million units of money from circulation during the year. In general, the Central Bank's yearly **issue of money** totaled to AZN1.87 billion or 50.1 million units, against the last year's AZN1.3 billion (28.2 million units).

Just as in the previous years, the Manat's **security systems and technical qualities** once again proved to be fully compliant with the latest requirements in 2011. Assessments show that the Central Bank discovered only 575 units of counterfeit money

Table 13. Cash in circulation by bank notes

Bank notes	Amount, AZN mil	Millions of units
1	44,9	44,9
5	95,0	19,0
10	151,9	15,2
20	369,2	18,5
50	1607,3	32,2
100	5349,7	53,5
Total	7618,1	183,2

Source: CBA

(AZN16 043) in 2011. Compared to the relevant international experience, if only 1 counterfeit bank note is identified by the Central Bank for every 10-20 thousand bank notes in circulation, it means that there is only 1 counterfeit bank note for every 300 thousand bank notes circulating in Azerbaijan.

The process of destroying new generation bank notes (AZN) was continued in 2011 under the Regulation for **Destruction of Bank Notes** Withdrawn from Circulation, other than Counterfeit Money, as approved by the Cabinet of Ministers of Azerbaijan Republic. The Working Group of the State Commission for destruction of bank notes withdrawn from circulation established by a Presidential Decree, destroyed AZN637.6 million worth of 200.6 million units of AZN notes, at a daily burning rate of 900 thousand units, and regularly reported to the Cabinet of Ministers of Azerbaijan Republic to this effect. No faults were detected in course of re-count and destruction of bank notes.

The process of withdrawing the old design bank notes (AZM) from circulation continued in 2011 as well. Overall, 57.4 thousand units or AZN512.1 million AZM (equivalent of AZN102.4 thousand) worth of old design notes were destroyed during the year. 99% of AZM's in terms of amount were revoked and destroyed by the end of 2011.

The Central Bank also continued to follow its earlier adopted policy of **issuing anniversary and memorial coins**. Thus, in 2011 the Central Bank prepared and issued golden coins in commemoration of the 135th anniversary of the National Press and the 20th anniversary of Restoration of National Independence of Azerbaijan Republic.

11.2. Cash management

The Central Bank took necessary measures to ensure that cash management meets best international practices, treasury infrastructures are optimized and upgraded to fully comply with international standards, cash-related business processes are entirely safeguarded and risks are minimized.

The Central Bank advanced further with the implementation of the fully automated **Cash Center** project in accordance with the international standards in order to introduce best international practices of effective and safe cash management.

Furthermore, as commissioned by the President with respect to the maintenance and management of the country's gold reserves, the Central Bank set out to establish a Gold Treasury considered a reference model in developed countries.

The Central Bank initiated the **Creation of the Integrated Cash Management Information System (CMIS)** for Cash Management project, which is essentially a multi-module system that implies complete automation of all cash-related business processes and data flows across all of the Central Bank's treasury infrastructures and relationships with commercial banks, as well as the establishment of an online database necessary for efficient decision-making.

The Central Bank carried on with streamlining the **Regional Centers** (RM) to compliance with international standards set up in 5 of the country's regions with an aim to optimizing and upgrading the treasury infrastructures, ensuring appropriate safeguards and minimizing the inherent risks, and identified new functional frameworks in accordance with the policy of developing contemporary Regional Central Banking.

To this effect, the Central Bank completed the construction of, and commissioned the Alternate Center in the town of Yevlakh; the Guba Regional Center's new office building was also completed.

Formation of business processes was initiated in accordance with international practices for ensuring security, expert assessment and anti-counterfeit measures relating to bank notes. An institute for expert assessment of bank notes was established based on lead countries' experience and with the assistance of relevant experts.

In 2011, the Central Bank continued its endeavors to execute the **Clean Money in Circulation Policy it** had announced in pursuit of improving the quality of national bank notes in circulation, preventing counterfeit attempts as well as increasing the behavioral culture of bank notes; the Bank managed to maintain a high quality of bank notes in circulation.

The Central Bank's Head Office and Regional Centers continued to replace bank notes accepted from the public. The Head Office and Regional

Centers' transactions with individuals totaled to AZN1.4 million, of which 50.8% (AZN725.0 thousand) pertained to the Head Office, while RM's accounted for 49.2% (AZN702.7 thousand).

Two commercial banks launched **service to the public days** initiative, with methodological support of the Central Bank, in an attempt to efficiently respond to increasing cash-related requests from the public, as well as to provide appropriate expert assessment and replacement of bank notes.

With a view to improving the quality of cash-related services and ensuring timely supply of bank notes to ATM's, Cash Offices were established outside the head offices of the International Bank of Azerbaijan and Kapital Bank, with policy support from the Central Bank and a set of special policies and procedures were developed to cover their operations; as a consequence of these efforts, the bank note supply of ATM's was intensified.

The **Mobile Cash Desks** set up at the CBA's Head Office and Ganja RM with an aim to intensifying coin circulation carried on with their operations as planned in 2011. The Cash Desks injected 12.6 million units (AZN2.3 million) of coins, which represents 34% (31.3% in terms of units) of coin money withdrawn from circulation year-to-date in terms of value. In 2011, the Cash Desks' coin injections increased by 64.3% in terms of value and 28.6% in terms of units against the 2010 level.

Press-events were organized to address the cash management-related issues included awareness raising sessions titled "Cash in economy and the Central Bank's role and policy of cash management" and "Design and conduct of expert assessment of bank notes".

XII. DEVELOPMENT OF INSTITUTIONAL MANAGEMENT AT THE CENTRAL BANK IN 2011

Considering the Central Bank's aim for complete and credulous fulfillment of its mission, it appears that managing its institutional aspect of operations in accordance with the best central banking practices is strategic. To this end, the CBA set up a new institutional management framework meeting best international standards in 2011. This framework's scope ranges from operational measurement to planning to organization, monitoring and assessment.

The new institutional management framework is grounded in the Targeted Management philosophy. Under this framework targets are initially identified for the Bank's overall operations; such targets are referred to as corporate targets. Then, targets are set for the Bank's business units. Following that, business unit targets turn into individual targets.

The new management system allows for accomplishing institutional goals in three parallel interconnected ways:

1. To continue the existing operating processes and ensure that they are not disrupted;
2. To improve and refine operating processes constantly;
3. To modify institutional operations by introducing new functional products or new business (operating) processes.

The Bank plans, organizes and evaluates its work under each of the above three methods using a single institutional management framework composed of two parts: operating management and strategic management.

The operating management framework plans, implements and evaluates the first and second elements of institutional operations: a) undisrupted continuation of the existing operating processes; b) constant improvement of operating processes.

In 2011, the Central Bank of Azerbaijan passed its fourth strategic planning period. In the previous strategic planning period the Central Bank succeeded in executing its mission and functions as well as in achieving its goals and objectives.

With the ever-growing requirements set forth by the 21st century coupled with the country-wide modernization strategy, the Central Bank found itself compelled to introduce a new strategic management framework, which also needs to be improved on a regular basis. In this view, the Central Bank carried on with its endeavors to build a new Strategic Planning and implementation and monitoring framework in accordance with best international practices.

The **Central Bank's newly developed strategic planning model** is grounded in the top-down vertical distribution of goals and objectives. The new approach requires the top management's active support and involvement in strategic planning so as to ensure its success.

A Strategic Modification Group was established as part of the Bank's process of developing the 2011-2014 Strategic Plan, with a view to ensuring that organizational processes are managed in a more effective manner under the supervision of the Central Bank's Governor. The Group proved to have been instrumental in carrying out external and internal environment assessments, developing strategic goals and objectives at the overall corporate level, as well as subdividing such goals and objectives into tactical targets at functional levels. The analysis of functional activities and necessary resources by all departments played a key role in assuring a proper evaluation of the Bank's institutional capacities and its ability to address challenges as required.

The current situation analysis was structured as a process of bottom-up flow of analytical information. The Central Bank carried out the current situation analysis in two phases. The first phase analysis was conducted by the individual business lines of the Bank, while the second phase combined the findings of all analyses for submission to the Management Board. The Bank's business lines carried out their current situation analyses using the Integrated Model of Value Chain and Strategic Gap Analysis.

The Central Bank's new Strategic Plan covers the years of 2011-2014, however, adjustments can be made annually, as necessary. The next strategic period defines the Bank's new priority areas as follows:

- substantive modernization and improvement of the principal functional areas to international standards;
- development of a state-of-the-art corporate governance system;
- formation of a contemporary and strong human capital;
- greater input to the country's economic development strategy.

The Strategic Plan identifies nine strategic goals to be achieved over the four year period. The Central Bank used foreign technical assistance broadly in developing the Strategic Planning framework to ensure its consistency with the systems employed by the world's most developed central banks.

Execution of the strategy, effective management of this process as a whole is one of the most complex elements of the strategic management cycle. Execution of a strategy is essentially implementation of changes. And institutional changes do not simply imply modifications of internal operating processes or technologies, they also herald innovations in the sets of skills and knowledge, corporate culture, management methods.

With an aim to effectively executing the strategy the Central Bank employed new methods and approaches in 2011, learning from international experience. Any organization needs to build a new potential to facilitate institutional changes and achieve its strategic objectives, and thereby harvest strategic outcomes and benefits. The new potential implies introduction of state-of-the-art business processes, implementation of cutting-edge technologies, development of skill and knowledge sets and management systems, while gaining strategic outcomes and benefits reflects the Central Bank's accomplishments in discharging its functions and fulfilling its mission at a whole new level of quality.

This chain process is currently managed through a three-tier management system at the Central Bank. The Bank's new capacity building endeavors are carried out under the overall project management efforts. The CBA's project management is based on the internationally accepted PRINCE-2 model, which allows for precise identification of the scope, quality, timeline, risks, costs and finally the objectives of the works to be done under a given project. The institutional capacities generated as a result of project implementation are subsequently transformed into strategic benefits using programs and portfolio management that controls the dependencies between such programs. To this end, the CBA implemented the Successful Program Management framework in 2011, the most state-of-the-art program management method.

Presently the CBA developed and had approved seven Program Documents and thirty four project documents in accordance with best international practices for implementation of the 2011-2014 Strategic Plan. The approved documents distribute the four year strategic operations among monthly and decade tactical objectives, determine their logical interconnections, identify the outcomes and benefits of works to be done, scope the necessary division of works, competencies and responsibilities, and lay out the reporting requirements.

Overall, the three-tier management system involves the entire Bank staff in the strategic implementation process, compelling them to be creative, innovative, active, in addition to fostering leadership skills and helping discover talents.

Presently the Central Bank continues its work on developing a new framework for **monitoring strategy implementation**. The best practice-based framework allows for a more effective evaluation of institutional performance. The CBA currently employs the 'management panel' method to monitor its institutional performance.

The management panel is a framework used to manage and monitor the Bank's performance. This framework identifies the core performance indicators and objectives for the Bank's functions, functional products and business processes, which allow for measuring and appraising the Bank's performance. Furthermore, each individual activity is evaluated and good, model activities are rewarded.

In practice, the Central Bank's performance is appraised by the Management Board on a quarterly, semi-annual and annual basis. Performance appraisal of lines of business is addressed by policies approved by the Management Board.

XIII. HUMAN RESOURCES MANAGEMENT

The Central Bank continued to place a special focus on human resources management in accordance with international standards and corporate values in 2011.

New economic environment render the development of human capital the quality of being a key element for successful implementation of the Central Bank's mission statement and its institutional development. In this view, the priorities set for the new strategic period included upgrading of the personnel's competencies, fundamental skills and knowledge in consistency with the changing requirements, to a level at which they would meet modern central banking standards. To this end, the Central Bank launched the competence-based **project of Establishing a Human Resources Management System (HRMS) to Motivate High Output Individual Performance and Development**, which is expected to boost the HR development in the reported year. The scope of the project includes harmonizing of the bank's training, incentive, career building and other management systems responsible for human resource development and motivation with the contemporary standards.

The Bank's efforts at building an adequate staffing capacity had the benefit of attracting candidates with higher qualifications and certification to the CBA's hiring process. For instance, the CBA established fruitful relationships with the foreign alumni association of Azerbaijan, thus being able to draw on a pool of graduates of reputable international universities. As a result, the CBA processed 627 applications, hiring 36 applicants, 25% of which are foreign educated specialists. In addition, 29 employees were promoted during the year. Furthermore, given the CBA's structural adjustments and the constantly changing economic settings, the HRD was compelled to upgrade its automated test framework, modifying the existing question sets, and revised the Recruitment Qualifications catalogue in this context.

The Central Bank and the banking sector as a whole continued to benefit from the **Internship Program**, which had a positively great input to the institutionalization of training processes, while also helping identify and educate young and promising bankers-to-be. In 2011 210 candidates representing 10 local universities and 6 foreign universities (England, USA, France, Germany, Italy, Turkey) applied for internship with the Central Bank. Consequently, the Central Bank invited 65 interns to 17 departments. Following completion of their internship, some interns chose to apply for full-time employment and, after having been duly processed, 7 candidates

Table 14. Central Bank's 2011 HRM statistics

Overall for Central Bank												
				Education statistics (training/person)								
				In-house training			Outsourced training				External training
New hires	Dismissls	Promotions	Of which, based on seniority	Specialization	Management	Additional skills	Experience exchange	Semi nar	Certification course	Other	
36	33	29	10	18/432	3 / 63	3/46	22/31	92/102	24/24	8/8	3/79

Source: CBA

were hired, which makes roughly 20% of the Central Bank's overall hiring in that year.

The Central Bank sought to make the **education** process more skill-oriented and effective, using new, progressive forms of training during the reported year. Placing a special focus on certification levels, the Central Bank had 12 of its employees awarded with international certificates. Overall, the number of the bank's employees to have undergone training courses in 2011 increased by up to 30% against the previous year's level. Outsourced training activities consisted primarily of experience exchange, seminars, certification courses, scholarship programs, forums, etc.

Another focal point of the Bank's training efforts was **the language proficiency of personnel**. As part of this endeavor, a competent service provider certified the language skills and examined the language proficiency potential of the Bank's personnel, in addition to preparing relevant development proposals to this effect.

The Bank implemented the **Electronic (Distant) Learning** project to provide its staff members with on-the-job skill development opportunities, in the overall context of employing state-of-the-art, progressive forms of education. The distant learning program covered 40 employees during the reported year through 48 topic modules and related 351 sub-topics; the learning process closed with 96 tests covering the program's topics.

The reported period's biggest achievement in terms of improving the adaptation program's quality as well as strengthening the CBA's overall internal communications and delivering various training materials more rapidly was the **Human Resource** Portal. During the year, the portal was supplemented with a number of new functionalities and modules; activating the Publications and Articles module, it was periodically published under relevant sections in Harvard Business Review, The Economist and Bloomberg Newsweek magazines. Incorporation of a new module (staff member's personal profile) for the portal is nearing completion.

Employee motivation and performance appraisal represent core components of the Central Bank's human resources policy. With a view to increasing the effectiveness of the performance appraisal process, the Bank took measures to ensure consistency among other HRM procedures coordination and time-wise; the Bank completed the appraisal of its personnel's performance in 2010. Outcomes of this exercise were used to substantiate promotions and non-motivational measures were taken with respect to the employees in question. **The HRM process automation** was continued. A number of modules devised in conjunction with Deloitte & Touche LLC have already been commissioned.

XIV. COMMUNICATIONS OF THE CENTRAL BANK

The strategic objectives of the Central Bank's communication policy were devised on the over-reaching premise of enhancing public confidence in the Bank by improving the transparency of its operations, ensuring that the general public perceives the Bank's vision and mission statement as they are intended and providing an input to economic awareness of the general public.

The **Central Bank developed a strategic communication activity program** for 2011-2014 with due consideration to the global development trends as a means of effective implementation of the communication policy. The program contains a set of sub-strategic objectives such as creation of a communication system in compliance with best international practices, creation of an internal communication system supporting the development of corporate culture as well as development of corporate social accountability and implementation of related projects. The communication strategy was designed along the lines of the latest innovations and approaches used by the world's lead central banks.

In the reported year, the Central Bank worked to set up a communication system in consistency with international standards. **Improvement and institutionalization of the Central Bank's data transmission process** was set as a priority task under the communication management endeavour.

External communications were assigned a special place in the Central Bank's overall communicative arrangements because they greatly bear on the ability of all of the Bank's target groups to deliver operating and institutional data in a clear context and as quickly and consistently as possible. To this end, communicative projects aimed at other target groups were implemented during the reported year in addition to the expanded scale of relationships with both local and foreign mass media. Press-releases covering a variety of topics were disseminated through the Central Bank's web-site and mass media. Seeking to increase the effectiveness of press-release dissemination, the Central Bank worked to refine their contents to cap the informative enhancements it had already made.

The Central Bank established effective working contacts with foreign mass media as well, taking them up yet another notch of professional and business relationships. The mass media outlets the Bank has built relationships with include Reuters, Bloomberg, Central Banking, RBK-Russia news agencies, Euromoney, Le Nouvel Economiste, Деньги и Кредит, Вопросы экономики, Forbes, BusinessNewEurope, Valeurs Actuelles, Financial Journal, The Banker magazines and The Guardian, USA Today newspapers. These agencies and print press published details on the most significant occurrences in Azerbaijan's banking system at a global scale.

The Central Bank's **web-site** (www.cbar.az), which is regarded as the principal source of communication for target groups, was upgraded during the year, both in Azeri and English; this important communication portal's database was regularly updated during the year. The web-site has undergone certain changes, with new sections and sub-sections introduced and design and content improvements made. The number of the Central Bank's web-site increases by the year. In 2011 o average 27000 unique users accessed the web-site, which exceeds the 2010 level by 40%. Regular visitors include users from Russia, USA, Great Britain, Turkey and Germany. The Central Bank's web-site was awarded the Best Government Web-Site of the Year prize in the Netty competition carried out by the Ministry of Communication and Information Technologies of Azerbaijan Republic.

Communication support was organized for the **Days of Azerbaijan event hosted by the World Bank's Washington, D.C., office on March 15-16, 2011**. As such, the CBA Governor gave interviews to Reuters, as well as The Guardian, the World Bank's internal portal, and the local Azertac State Telegraph Agency. The event was widely covered by the Xalq, Azerbaijan, 525-ci qazet, Respublika, Zerkalo and other local newspapers. The Azerbaijan Broadcasting Company's Xeberler and Hefte news shows, and ATV's Son Xeber news show aired reports on the event. A web-site was created specifically for the Days of Azerbaijan event and a documentary film was made covering this occurrence.

During the reported year the Bank worked to expedite the process of communicating information to mass media in response to telephone, mail and e-mail inquiries in a rapid and complete fashion. As a result, about 100 journalist inquiries were responded to.

Communicating the Central Bank's significant projects was a priority task in 2011. Communication coverage was provided for the presentation of the KOMIS (Bulk Payment Centralized Information System) project, the opening ceremony of the National Hero Mubariz Ibrahimov Lyceum School in Bilesuvar, built with the Central Bank's support, and other important events.

The principal objective of the Central Bank's **internal communication** policy is to communicate the Bank's objectives, activities and each staff member's role in the Bank to the personnel.

Forming up an in-house system of corporate values and culture, establishing effective internal communication between the Central Bank's employees, building an effective management-employee dialogue were identified as strategic objectives of the Bank's internal communication development.

Perfectly realizing its corporate social responsibility to the society for increasing **public awareness**, the Central Bank endeavored to increase the financial awareness and education of the generations to come, which will play a key role in the national economy, and the general public as a whole. In this view, a training course on Central Banking was arranged for mass media. The training course included a series of training sessions covering a variety of topics explained to about 20 journalists, such as major macroeconomic and monetary terms, the role of payment systems in the economy, macroeconomic diagnostics system, objectives and framework of the

Box 15. The 20 year long history of the Central Bank of Azerbaijan

As a vital government entity, the Central Bank has played a key and unique role in fostering and supporting the country's economic sustainability. The Central Bank's accomplishments in banking reforms and macroeconomic stability have historically proven their ability to withstand any tests of time.

The Central Bank started its operations when the country lived through a horrific period of a heavy political and economic crisis, military aggressing and was essentially on the verge of a civil war. Economic transformation leaning on a shock therapy recessed into a deep abyss. Hyperinflation and poverty were striking critical levels. The country had little to zero foreign exchange reserves. The financial sector was bankrupt.

Arrival of the national leader H. Aliyev reversed the situation. Benefiting from his far-sighted political and economic strategy, Azerbaijan eased out of the chaos into stability and continuous development. Transition to market-based economy was swift, macroeconomic stabilization and structural adjustments were successful.

The Central Bank contributed greatly to these achievements. The country has enjoyed sustainable macroeconomic stability as a result of the Central Bank's concerted effective efforts with other economic authorities over the past years. Azerbaijan's 20th ranking among world countries in terms of macroeconomic stability is no chance. Low inflation rates have been instrumental in reducing poverty. The Manat has become the most sustainable and credible currency in the region.

The banking sector has successfully completed the transformation process, implementing radical restructuring and consolidation programs. A financial infrastructure meeting best international practices, as well as state-of-the-art electronic payment systems and postal banking system have been established. Micro-financial institutions and mortgage lending have been developed.

As a result, the nation benefits from a liberal, highly rated financial and banking sector that provides a diversified range of state-of-the-art financial services. The level of public confidence in the banking system is high. Banks have played a key role in economic diversifications. Banking laws have been improved to comply with best international practices, an effective bank supervision function has been set up. A new generation bank notes has been put into circulation, which meet the latest security and aesthetic standards.

The country's economy managed to survive 2 global economic crises as a result of the Central Bank's concerted efforts with the government of Azerbaijan. The country managed to maintain its macroeconomic stability and banking system's stability during both the 1998 Asian Crisis and the 2008-2009 global financial crisis.

monetary policy, the Central Bank's communication strategy, bank supervision, foreign exchange reserves management, CBA's human resources management strategy, cash management, the monetary policy's channels of impact on the economy.

The Central Bank's Research and Development Center joined efforts with the Communication Department to organize a number of events and lectures in 2011. The students had the opportunity to attend the Career Day, while lectures on the PR concept and the economy, the banking sector and the monetary policy were delivered at the Media Academy.

In celebration of its 20th anniversary, the Central Bank sponsored the production of a documentary and issued memorial stamps and coins, organized an essay competition on the Central Bank's role in Azerbaijan's economy and a roundtable involving young economists entitled “Macroeconomic policy: Global challenges and national imperatives”.

In addition to ensuring effective external and internal **communication of the Central Bank's management**, management communication served the purpose of creating a positive perception of the Bank as a professional, contemporary, transparent and accessible entity. Apart the international interviews of the Central Bank's Governor, his media addresses and speeches were widely covered in foreign press; furthermore, the E-mails from the Governor tradition was set off in an effort to reinforce internal communication.

XV. INTERNAL AUDIT

As the Central Bank's unit responsible for evaluating the effectiveness of risk management and internal control systems and supporting improvements in management processes, the Internal Audit function carried on with its advisory and assurance work in 2011.

The internal audit function audited the Central Bank's head office and Regional Centers looking into major risk areas based on the Central Bank's risk map, in accordance with the audit plan, and provided recommendations with regards **to improvements and security measures for the internal control system**. The internal audit function prefers preventive control as a measure of increasing performance efficiency.

The Internal Auditors Institute's standards were widely used during the audits. The audits assessed the Central Bank's internal control system using 5 principles of the COSO standards (The Committee of Sponsoring Organizations of the Treadway Commission). Criteria based on the 'best practice' matrix and scorecard principles in this field were used for objective evaluation of the internal control system. In addition, evaluation criteria were developed for 6 elements of the control environment component of the internal control system, given the current situation of the Central Bank.

An area of focus for the audit function was the inspection and oversight of **information technology risk management** and security issues. The internal audit function adhered to the Internal Auditors Institute's and Information System Audit and Control Association's (ISACA) standards and COBIT 4.1 and ISO 27002 standards when evaluating and analyzing information technology risks and providing its assessment and recommendations. The adequacy of control arrangements and monitoring tools was analyzed and examined in accordance with the procedures and policies relating to the above evaluation standards.

The audit function examined the Bank's software complexes, operating infrastructure and systems, current conditions and security parameters of the hardware, compliance of configurations with the relevant procedures, information exchange security issues. An integrated risk assessment was carried out with respect to information security, recommendations were provided for improving the Central Bank's information security and putting in place effective and efficient controls.

Priority processes and risks were analyzed in consistency with the adequacy levels under the 34 processes identified in the COBIT information technology standards (Information technology-related control issues) employed by the Central Banks, improvement recommendations and advisory services were provided.

The internal audit function continued to work closely with the Internal Auditors Institute and the Information System Audit and Control Association (ISACA), the world's professional associations engaged in vocational certification, **training and policy development.**

XVI. INFORMATION TECHNOLOGIES OF THE CENTRAL BANK

The priority areas of focus for information technologies in the reported year included automation projects in the operating, accounting and management lines of business, with due consideration of the global IT tendencies and the existing development challenges in information and communication technologies, as well as the development of a strategic vision in accordance with best international practices and execution of an audit in compliance with international standards.

The Central Bank's approach to information technologies is characteristic of taking appropriate measures to ensure reliable and undisrupted operation of the Bank's IT systems and working expediently to modernize their hardware and software components, alongside being constantly on the lookout for any information technology innovations that may befit the Bank's operational profile. Thus, Temenous General Ledger, Automated Bank Statistical Report, Centralized Credit Registry, internal communications, local network, Archive/Records, Fina (Prudential Reporting System for Credit Institutions) systems as well as the Central Bank's web-site operated during the year in full compliance with the relevant policy documents and methodologies.

The **Temenos General Ledger System** (GLS) was completed and the software complex was put in real life operation on 05.01.2011. This initiative is one of the Central Bank's projects devised to fast-track the development of the financial system infrastructure and improve access to financial services as well as to upgrade the Central Bank's operating and accounting areas. The GLS designed off of a new platform allows for faster execution of accounting operations, realization of all possible automation processes in order to minimize human involvement, enables client government entities to directly manage client accounts online and availed Regional Centers of setting up remote workplaces.

The Central Bank continued to work on implementing the **WallStreetSuit Portfolio Management System** (PMS), which will be used in foreign exchange reserves management and will provide relevant risk measurements and projections; the associated software package was developed in parallel. An interface was built linking Temenos BMS and WallStreetSuite PMS to support regular reciprocal operation of the Central Bank's accounting and operating processes; the software packages of the two systems have been upgraded to allow for data flows as required.

Special attention was given to the **Human Resources Management System**, one of the Central Bank's projects for management process automation and improvement of performance effectiveness and efficiency. The cutting-edge HR process management solution, Oracle E-Business Suite will be used as a platform for building an electronic functionality to be operated as a means for complete automation of electronic employment, HR planning and evaluation, motivation and education processes through integration with the Bank's web-site. In the inception phase, the software package includes already operational employment, HR planning and evaluation modules.

The **Banking Sector's Management Information System** (MIS) has been completed with a view to enabling the CBA to keep track of the banking sector and financial infrastructure's dynamic development and improvement tendencies. Thus, the system currently processes the banking sector's statistics and prudential reports as well as registers all activities and changes taking place in the sector. As a continuation of these works, the automation components of the **Electronic Paperwork/Clerical System** have been completed in order to intensify the processing of consumer requests, switch intrabank communications from paper medium to electronic carriers and employ the electronic signature tools of the Central Bank's **Electronic Signature Certification Center** used for document flows. Thus, one of the primary objectives of developing this system was to ensure successful integration of the Central Bank with the Electronic Government platform, a major component of the State Program “Electronic Azerbaijan”.

The Central Bank continued its work on establishing the **Oracle Business Intelligence Electronic Statistic Database and Analytical Reporting System** with a view to automating business processes to setting up a state-of-the-art and standardized statistical platform and collecting and disseminating the aggregate external debt and international investment balance sheet statistics. Once put in place, the system will have formed a single-source statistical database keeping a comprehensive track of the real sector as well as measuring the economic conditions and evaluating the corporate sector's financial stature.

Creation of a fully automated modern treasury infrastructure and formation of a new cash management system draws the eye among all IT-related automation projects. To this effect, foreign experts were engaged to help develop the concept of the **Cash Management Information System**, which will combine a set of functionalities for designing and examining bank notes, forming a new reporting system and economic analysis framework and modeling the future development of cash management processes. Bids were invited in accordance with the applicable public procurement laws to identify the winner that will implement the project at the Central Bank.

The Central Bank never ceased to pay particular attention to developing information systems and putting their operations on a single platform basis, whereby all record-keeping and operating processes will be managed in a centralized manner. To this end, a fiber optical lines were laid to connect the Central Bank's head office with Regional Centers (Treasury No.2, Sumgayit Alternate Center, Nakhchivan AR Office, Bilesuvar, Yevlakh, Ganja, Guba Regional Centers) and a **Global Network was** set up with appropriate encryption safeguards. This arrangement allows Regional Center employees to access the information systems via the Global Network.

The Central Bank engaged Deloitte & Touche to provide international audit advice regarding the development of a short-term and long-term strategic vision respecting information technologies and management and improvement of information security, as continuation of the works aimed at building and regularly upgrading information technologies in accordance with best international practices. The auditor's assignment implied an audit with a subsequent audit report on the Central Bank's performance in terms of analytical work based on COBIT and ISO 270001 standards, evaluation of the Maturity Model, operation, management and security of the information technology infrastructure.

XVII. INTERNATIONAL RELATIONS OF THE CENTRAL BANK

As part of its efforts to successfully execute its principal mission, the Central Bank continued to work hard on building and developing its foreign relations and international collaboration in 2011.

Current projects were continued and new projects were introduced during the reported year, the Bank's management held high level meetings and organized seminars in conjunction with foreign central banks; strategic dialogue and partnership relations with international financial institutions and development agencies were reinforced; measures were taken to build new contacts; and international events were organized with the CBA's principal input. The events helped the CBA to accomplish its strategic objectives, benefit from the expertise of international institutions and foreign central banks well-versed in reforms and modernization efforts and refine the CBA's representation at an international scale.

Fruitful cooperation with the **World Bank** (WB) was continued during the reported year. Under the overall collaborative framework, advisory services were arranged for the chairmen of the Supervisory Boards and Management Boards of local commercial banks. The CBA's most significant advancement towards a refined international perception of the Central Bank was the Days of Azerbaijan event hosted by the WB's Head Office in Washington, D.C., in 2011. This event had the principal objective of celebrating the World Bank's long-standing record of fruitful cooperation with Azerbaijan, taking up the dialogue with this institution to yet another level and introducing foreign guests to Azerbaijan's culture. A number of high-level meetings were held in the course of the event.

The meeting discussions primarily addressed the WB's history of relations with Azerbaijan, accomplishments of both sides as a result of cooperation and future prospects thereof, the WB's country economic development strategy, loan portfolio with Azerbaijan, importance of mutual intellectual sharing, joint projects of Azerbaijan and the WB, development of Azerbaijan's banking sector, the Central Bank's policy.

In addition to the official program, the WB's offices hosted a carpet and silk exhibition, a photo gallery; a live carpet weaving and traditional clothes were staged; traditional meals of Azeri cuisine were offered to WB and IMF employees in the banquet room, accompanied with classical Azeri music. Pictures and posters depicting Azerbaijan's rich cultural legacy, views of Baku, as well as the views of the country's economic development and growth were put on display; short videos about Azerbaijan were played later on.

IMF experts visited the CBA to discuss Paragraph IV of the Articles of Agreement with the **International Monetary Fund** (IMF); meetings held covered a range of issues such as preservation of macroeconomic stability and the banking system's sustainability, Azerbaijan's efforts to minimize the effects of the global financial crisis on its economy, the CBA's near-term plans with respect to the monetary and exchange rate policy, etc. The Central Bank invited the IMF's technical assistance for monetary policy and statistics, and worked closely with the Fund's experts to coordinate the upcoming activities under the 2012 Financial Sector Assessment Program.

Cooperation with foreign central banks represented a principal area of interest for the CBA in terms of international relations in 2011, wherefore the Bank continued to pay particular attention to raising central banking partnerships to higher levels and ensuring strategic dialogue with other central banks. CBA representatives went on study tours to the National Bank of Poland for human resources management and international relations development; the National Bank of the Czech Republic for improvement of risk-based bank supervision; the Central Bank of Turkey for improvement of the Governor's Office performance; the Bank of Russia and the European Central Bank for communications; the Bank of France for strategic management and information technologies; the Bank of Italy for international relations development; the Bank of Switzerland for strategic management and communications.

The **CBA also carried on with its donorship** in 2011 by arranging study tours for representatives of partner central banks to the CBA for experience sharing on the CBA's financial reporting, registration of bank transactions in automated systems and maintenance of the general ledger, use of international standards in estimating the scope of issue of the national currency.

Cooperation with international development agencies was also successfully continued during the reported year.

Technical assistance projects provided with the assistance of the US Agency for International Development (USAID) were coordinated, including institutional capacity building for the Financial Monitoring Service, development of an automated cash management system, enhancement of the risk-based bank supervision, improvement of the institutional framework of strategic management and enhancement of the CBA's financial management capacities.

The Swiss Secretariat for Economic Affairs (SECO), under its Technical Assistance and Training Program, provided training, policy and advisory support for improvement of the balance of payment preparation and financial programming, as well as for project managers involved in project management.

Risk Management, Project Management, Asset and Liability Management and Effective Leadership seminars were organized in conjunction with the Agency for Transfer of Financial Technology (ATTF).

With the support from the Turkish International Cooperation Agency (TIKA), the CBA's legal, bank supervision, communication and security staff attended training courses delivered at the Central Bank of Turkey.

With the assistance of the Korean International Cooperation Agency (KOICA), the Central Bank benefited from the advisory services provided by international experts on a complete diagnostic and improvement of the IT system, implementation of the electronic signature tool, and upgrading of the CBA's IT system to COBIT 4.1 standards, under the 'Information Technology Management and Improvement of the Security System of the Central Bank' project.

XVIII. CENTRAL BANK'S 2011 FINANCIAL STATEMENTS

Independent Auditor's Report

To the Management Board of the Central Bank of the Republic of Azerbaijan:

1 We have audited the accompanying financial statements of the Central Bank of the Republic of Azerbaijan (the "Bank") which comprise the statement of financial position as of 31 December 2011 and the statements of comprehensive income, changes in equity and cash flows for the year then ended and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

2 Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

3 Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

4 An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

5 We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

6 In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Bank as of 31 December 2011, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

PricewaterhouseCoopers Audit Azerbaijan LLC

20 April 2012
Baku, Azerbaijan

Statement of Financial Position

In thousands of Azerbaijani Manats	Note	31/12/2011	31/12/2010
ASSETS			
Cash and cash equivalents	7	6,682,504	3,763,455
Special Drawing Rights holdings with the International Monetary Fund	8	185,029	189,638
Trading securities	9	1,506,339	754,707
Loans to local banks	10	2,080,159	1,912,718
Investment securities	11	361,483	1,046,106
Promissory note from the Government	22	221,095	216,472
Premises and equipment	12	40,977	33,947
Intangible assets	12	9,617	8,628
Other financial assets	13	3,965	5,844
Other assets	14	46,433	45,370
TOTAL ASSETS		**11,137,601**	**7,976,885**
LIABILITIES			
Money issued in circulation	15	7,658,486	5,793,219
Amounts due to credit institutions	16	867,697	732,905
Amounts due to government organizations	17	2,503,224	1,254,212
Amounts due to other organisations	18	4,678	2,404
Debt securities in issue	19	50,185	34,193
Amounts due to international financial institutions	20	3,769	4,117
Liabilities on transactions with the International Monetary Fund	8	208,173	226,448
Other financial liabilities	21	2,150	5,417
Other liabilities		23	104
TOTAL LIABILITIES		**11,298,385**	**8,053,019**
EQUITY			
Charter capital	22	10,000	10,000
Capital reserves	22	209,517	209,517
Accumulated deficit		(380,301)	(295,651)
TOTAL EQUITY		**(160,784)**	**(76,134)**
TOTAL LIABILITIES AND EQUITY		**11,137,601**	**7,976,885**

The notes set out on pages 73 to 126 form an integral part of these financial statements.

Statement of Comprehensive Income

In thousands of Azerbaijani Manats	Note	2011	2010
Interest income	23	111,752	83,719
Interest expense	23	(2,118)	(1,028)
Net interest income		**109,634**	**82,691**
Impairment charge for interest-bearing assets	10	(5,963)	(12,903)
Net interest income after provision for loan impairment		**103,671**	**69,788**
Fee and commission income	24	7,884	5,131
Fee and commission expense	24	(724)	(2,009)
Losses less gains from trading securities		(9,948)	(14,744)
Gains less losses/(losses less gains) from financial derivatives	30	3,023	(3,542)
(Losses less gains)/gains less losses from trading in foreign currencies		(3,287)	3,126
Foreign exchange translation losses less gains		(136,789)	(130,942)
Other operating income	25	1,649	1,457
Administrative and other operating expenses	26	(50,129)	(31,053)
LOSS FOR THE YEAR / TOTAL COMPREHENSIVE LOSS FOR THE YEAR		**(84,650)**	**(102,788)**

Statement of Changes in Equity

In thousands of Azerbaijani Manats	Charter capital	Capital reserves	Accumulated losses	Total equity
Balance at 1 January 2010	**10,000**	**209,517**	**(192,863)**	**26,654**
Total comprehensive loss for the year	-	-	(102,788)	(102,788)
Balance at 31 December 2010	**10,000**	**209,517**	**(295,651)**	**(76,134)**
Total comprehensive loss for the year	-	-	(84,650)	(84,650)
Balance at 31 December 2011	**10,000**	**209,517**	**(380,301)**	**(160,784)**

The notes set out on pages 73 to 126 form an integral part of these financial statements..

Statement of Cash Flows

In thousands of Azerbaijani Manats	Note	2011	2010
Cash flows from operating activities			
Interest received		109,773	92,111
Interest paid		(2,000)	(765)
Fees and commissions received	24	7,884	5,131
Fees and commissions paid	24	(725)	(2,009)
Net losses from trading in trading securities		(12,227)	(14,744)
Net losses from financial derivatives		(84)	51
Net gains/(losses) from trading in foreign currencies		(3,287)	3,126
Other operating income received	25	1,649	1,457
Staff costs paid	26	(13,718)	(12,021)
Administrative and other operating expenses paid		(30,323)	(14,552)
Cash flows from operating activities before changes in operating assets and liabilities		**56,942**	**57,785**
Net increase in trading securities		(766,465)	(328,873)
Net decrease/(increase) in SDR holdings with the International Monetary Fund		1,511	(3,889)
Net increase in loans to local banks		(172,136)	(482,164)
Net (increase)/decrease in other financial assets		210	(73)
Net (increase)/decrease in other assets		32	(121)
Net increase in money issued in circulation		1,865,267	1,280,509
Net increase in amounts due to credit institutions		137,676	339,027
Net increase in amounts due to government organizations		1,258,668	277,893
Net increase/(decrease) in amounts due to other organisations		2,282	(889)
Net (decrease)/increase in other financial liabilities		(2,796)	92
Net (decrease)/increase in other liabilities		(63)	4
Net cash from operating activities		**2,381,128**	**1,139,301**
Cash flows from investing activities			
Acquisition of investment securities		(3,712,444)	(2,133,804)
Proceeds from sales/redemption of investment securities		4,387,090	1,868,239
Acquisition of premises and equipment		(11,787)	(14,727)
Acquisition of intangible assets		(2,335)	(3,436)
Net cash generated from/(used in) investing activities		**660,524**	**(283,728)**
Cash flows from financing activities			
Proceeds from debt securities issued		647,528	249,968
Repayment of debt securities issued		(631,575)	(223,791)
Repayment of borrowings from international financial institutions		(291)	(547)
Repayment of borrowings from International Monetary Fund		(15,153)	(10,144)
Net cash from financing activities		**509**	**15,486**
Effect of exchange rate changes on cash and cash equivalents		**(123,112)**	**(95,048)**
Net increase in cash and cash equivalents		**2,919,049**	**776,011**
Cash and cash equivalents at the beginning of the year	7	3,763,455	2,987,444
Cash and cash equivalents at the end of the year	7	**6,682,504**	**3,763,455**

The notes set out on pages 73 to 126 form an integral part of these financial statements.

Notes to the Financial Statements – 31 December 2011

1. Introduction

These financial statements have been prepared in accordance with International Financial Reporting Standards for the year ended 31 December 2011 for the Central Bank of the Republic of Azerbaijan (the "Bank").

Principal activity. The Central Bank of the Republic of Azerbaijan (the "Bank") is the central bank of the Republic of Azerbaijan, and is wholly-owned by the Republic of Azerbaijan. It acts in accordance with the "Law on the Central Bank of the Republic of Azerbaijan" effective from 10 December 2004 (the "Law").

Article 4 of the Law sets out the goals of the Bank, which are as follows:

- The primary goal of the Bank is to ensure, within its power, the stability of prices;
- Ensure the development and strengthening of the banking and payment systems; and
- Profit making is not a primary goal of the Bank.

Article 5 of the Law sets out the functions of the Bank as follows::

- Determine and implement monetary policy;
- Organize cash circulation; in accordance with paragraph 2 of article 19 of the Constitution and the Law: issue, put into circulation, and withdraw banknotes from circulation;
- Determine and declare the official exchange rate of Azerbaijani Manat;
- Implement foreign currency regulation and control;
- Maintain and manage the gold and foreign currency reserves at its disposal;
- Manage the drawing up of the reporting balance of payments and participate in the drawing-up of the projected balance of payments of the country;
- In accordance with normative acts issued in accordance with the Laws of the Azerbaijan Republic "On Banks", "On Post" and "On Central Bank of the Azerbaijan Republic", licenses and regulates banking activities and supervises banking activities subject to procedures established by legislation.
- Determine, coordinate and regulate activities of payment systems;
- Implement other functions as stipulated by the legislation.

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In accordance with Article 14.1 of the Law, the Bank cannot be declared bankrupt. Any deficit in capital is to be covered by the Government of Azerbaijan Republic. Refer to Note 22.

Pursuant to the legislation of the Republic of Azerbaijan and the international treaties acceded to by the Republic of Azerbaijan, the Bank represents the Republic of Azerbaijan in relations with the central banks of foreign states, as well as international financial and credit institutions in matters relating to the Bank's responsibilities.

The Bank may conclude agreements on cooperation with the central banks of foreign countries concerning various areas of its activities. It may also conclude clearing and settlement agreements and other agreements with foreign public and private clearing agencies, on its own behalf and on behalf of the Republic of Azerbaijan, if appropriately empowered.

The Bank may participate in the capital and activity of international organizations for the purpose of cooperation in monetary, foreign currency and banking areas.

At 31 December 2011, the Management Board (the "Board") of the Bank was composed of the following members:

Name	Position
Mr. Elman Rustamov	Governor
Mr. Alim Quliyev	First Deputy Governor
Mr. Aftandil Babayev	Deputy Governor
Mr. Vadim Khubanov	Deputy Governor
Mr. Khagani Abdullayev	Deputy Governor

Registered address and place of operations. The Bank's main office is located on the following address: 32 R. Behbudov Street, Baku, AZ1014, Azerbaijan. At 31 December 2011, the Bank had five regional branches in the Republic of Azerbaijan (31 December 2010: seven). As of 31 December 2011, the Bank had 617 employees (31 December 2010: 636).

Presentation currency. These financial statements are presented in Azerbaijani Manats ("AZN"), the national currency of the Republic of Azerbaijan, unless otherwise stated.

2. Operating Environment of the Bank

A well-developed business and regulatory infrastructure is being established in Azerbaijan as a country with a newly emerged market economy. A number of developments are being implemented that positively affect the overall investment climate of the country.

Over the last few years the Azerbaijani government and the Bank implemented significant reforms necessary to create banking, judicial, taxation and regulatory systems. Those measures also included the adoption of a new body of legislation and amendments to the existing legislation. These steps will contribute to mitigation of the risks incurred by entities doing business in Azerbaijan.

The reforms aimed at the overall improvement of the business environment are expected to continue. The future stability of the Azerbaijani economy is largely dependent upon these reforms and developments and the effectiveness of economic, financial and monetary measures undertaken by the government. However, the Azerbaijani economy is quite sustainable to market downturns and economic slowdowns in its partner countries. In spite of the fact the global economy is gradually recovering from the recession, persistence of significant risks remain in the global financial market and in capital markets instability. Growth and development of the Azerbaijan economy continued and sustainable macroeconomic stability was maintained at a time of such a situation in the global economy. The liquidity needs of the economy were fulfilled and stability of the exchange rate of the national currency was maintained thru anti-crisis measures of the Azerbaijani Government.

In addition to these, monetary policy and banking operations carried out in Azerbaijan can be subject to certain risks. Currently, all the necessary measures are implemented to support the Bank's role in maintaining macroeconomic and financial stability. However, especially sharp changes of fiscal parameters, including excessive fiscal expansion could affect the Bank's results and financial position in a manner not currently determinable.

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3. Summary of Significant Accounting Policies

Basis of preparation. These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") under the historical cost convention, as modified by the initial recognition of financial instruments based on fair value, and by the revaluation of available-for-sale financial assets, and financial instruments categorised as at fair value through profit or loss. The principal accounting policies applied in the preparation of these financial statements are set out below.

These policies have been consistently applied to all the periods presented, unless otherwise stated (refer to Note 5).

Financial instruments - key measurement terms. Depending on their classification financial instruments are carried at fair value or amortised cost as described below.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Fair value is the current bid price for financial assets and current asking price for financial liabilities which are quoted in an active market. For assets and liabilities with offsetting market risks, the Bank may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate. A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange or other institution and those prices represent actual and regularly occurring market transactions on an arm's length basis.

Valuation techniques such as discounted cash flows models or models based on recent arm's length transactions or consideration of financial data of the investees are used to fair value certain financial instruments for which external market pricing information is not available. Valuation techniques may require assumptions not supported by observable market data. Disclosures are made in these financial statements if changing any such assumptions to a reasonably possible alternative would result in significantly different profit, income, total assets or total liabilities.

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument. An incremental cost is one that would not have been incurred if the transaction had not taken place. Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisors, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

Amortised cost is the amount at which the financial instrument was recognised at initial recognition less any principal repayments, plus accrued interest, and for financial assets less any write-down for incurred impairment losses. Accrued interest includes amortisation of transaction costs deferred at initial recognition and of any premium or discount to maturity amount using the effective interest method. Accrued interest income and accrued interest expense, including both accrued coupon and amortised discount or premium (including fees deferred at origination, if any), are not presented separately and are included in the carrying values of related items in the statement of financial position.

The effective interest method is a method of allocating interest income or interest expense over the relevant period so as to achieve a constant periodic rate of interest (effective interest rate) on the carrying amount. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts (excluding future credit losses) through the expected life of the financial instrument or a shorter period, if appropriate, to the net carrying amount of the financial instrument. The effective interest rate discounts cash flows of variable interest instruments to the next interest repricing date except for the premium or discount which reflects the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates. Such premiums or discounts are amortised over the whole expected life of the instrument. The present value calculation includes all fees paid or received between parties to the contract that are an integral part of the effective interest rate.

Initial recognition of financial instruments. Trading securities and derivatives are initially recorded at fair value. All other financial instruments are initially recorded at fair value plus transaction costs. Fair value at initial recognition is best evidenced by the transaction price. A gain or loss on initial recognition is only recorded if there is a difference between fair value and transaction price which can be evidenced by other observable current market transactions in the same instrument or by a valuation technique whose inputs include only data from observable markets.

All purchases and sales of financial assets that require delivery within the time frame established by regulation or market convention ("regular way" purchases and sales) are recorded at trade date, which is the date that the Bank commits to deliver a financial asset. All other purchases are recognised when the Bank becomes a party to the contractual provisions of the instrument.

Derecognition of financial assets. The Bank derecognises financial assets when (a) the assets are redeemed or the rights to cash flows from the assets otherwise expired or (b) the Bank has transferred the rights to the cash flows from the financial assets or entered into a qualifying pass-through arrangement while (i) also transferring substantially all the risks and rewards of ownership of the assets or (ii) neither transferring nor retaining substantially all risks and rewards of ownership but not retaining control. Control is retained if the counterparty does not have the practical ability to sell the asset in its entirety to an unrelated third party without needing to impose restrictions on the sale.

Where the Bank has transferred its rights to receive cash flows from an asset and has neither transferred nor retained substantially all the risks and rewards of the asset nor transferred control of the asset, the asset is recognised to the extent of the Bank's continuing involvement in the asset. Continuing involvement that takes the form of a guarantee over the transferred asset is measured at the lower of the original carrying amount of the asset and the maximum amount of consideration that the Bank could be required to repay.

Where continuing involvement takes the form of a written and/or purchased option (including a cash-settled option or similar provision) on the transferred asset, the extent of the Bank's continuing involvement is the amount of the transferred asset that the Bank may repurchase, except that in the case of a written put option (including a cash-settled option or similar provision) on an asset measured at fair value, the extent of the Bank's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price.

Cash and cash equivalents. Cash and cash equivalents are short-term items which are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Cash and cash equivalents consist of cash on hand in foreign currency and unrestricted balances on correspondent accounts including overnight deposits and deposits with a maturity of three months from origination. Cash and cash equivalents are carried at amortised cost.

Trading securities. Trading securities are financial assets which are either acquired for generating a profit from short-term fluctuations in price or trader's margin, or are securities included in a portfolio in which a pattern of short-term trading exists. The Bank classifies securities into trading securities if it has an intention to sell them within a short period after purchase, i.e. within one month. The Bank may choose to reclassify a non-derivative trading financial asset out of the fair value through profit or loss category if the asset is no longer held for the purpose of selling it in the near term. Financial assets other than loans and receivables are permitted to be reclassified out of fair value through profit or loss category only in rare circumstances arising from a single event that is unusual and highly unlikely to reoccur in the near term. Financial assets that would meet the definition of loans and receivables may be reclassified if the Bank has the intention and ability to hold these financial assets for the foreseeable future or until maturity.

Trading securities are carried at fair value. Interest earned on trading securities calculated using the effective interest method is presented in profit or loss for the year as interest income. All other elements of the changes in the fair value and gains or losses on derecognition are recorded in profit or loss for the year as gains less losses from trading securities in the period in which they arise.

Loans and receivables. Loans and receivables including promissory note from the government are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They are not entered into with the intention of immediate or short-term resale and are not classified as trading securities or designated as investment securities available-for-sale. Such assets are carried at amortised cost using the effective interest method. Gains and losses are recognised in the current year profit when the loans and receivables are derecognised or impaired, as well as through the amortisation process.

Impairment of financial assets carried at amortised cost. Impairment losses are recognised in profit or loss for the year when incurred as a result of one or more events ("loss events") that occurred after the initial recognition of the financial asset and which have an impact on the amount or timing of the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. If the Bank determines that no objective evidence exists that impairment was incurred for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. The primary factors that the Bank considers in determining whether a financial asset is impaired are its overdue status and realisability of related collateral, if any.
The following other principal criteria are also used to determine whether there is objective evidence that an impairment loss has occurred:

- any instalment is overdue by more than ninety days and the late payment cannot be attributed to a delay caused by the settlement systems;
- the borrower experiences a significant financial difficulty as evidenced by the borrower's financial information that the Bank obtains;
- the borrower considers bankruptcy or a financial reorganisation;
- the borrower's credit rating is downgraded;
- there is an infringement of the original terms of the contract; or
- there is an adverse change in the payment status of the borrower as a result of changes in the national or local economic conditions that impact the borrower.

For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of the Bank's internal credit grading system that considers credit risk characteristics such as asset type, industry, geographical location, collateral type, past-due status and other relevant factors.

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets and the experience of management in respect of the extent to which amounts will become overdue as a result of past loss events and the success of recovery of overdue amounts. Past experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect past periods and to remove the effects of past conditions that do not exist currently.

The present value of the estimated future cash flows is discounted at the financial asset's original effective interest rate. If a loan has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

Where possible, the Bank seeks to restructure financial assets held at amortised cost rather than to take possession of collateral. This may involve extending the payment arrangements and the agreement of new terms. Once the terms have been renegotiated, the loan is no longer considered past due. Management continuously reviews renegotiated loans to ensure that all criteria are met and that future payments are likely to occur. If the terms of an impaired financial asset held at amortised cost are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms.

Impairment losses are always recognised through allowance accounts to write down the asset's carrying amount to the present value of expected cash flows (which exclude future credit losses that have not been incurred) discounted at the original effective interest rate of the asset. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss is reversed by adjusting the allowance account through profit or loss for the year.

Uncollectible assets are written off against the related impairment loss provision after all the necessary procedures to recover the asset have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off are credited to impairment loss account in profit or loss for the year.

Investment securities available for sale. This classification includes investment securities which the Bank intends to hold for an indefinite period of time and which may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices.

Investment securities available for sale are carried at fair value. Interest income on available-for-sale debt securities is calculated using the effective interest method and recognised in profit or loss for the year. All other elements of changes in the fair value are recognised in other comprehensive income until the investment is derecognised or impaired, at which time the cumulative gain or loss is reclassified from other comprehensive income to profit or loss for the year.

Impairment losses are recognised in profit or loss for the year when incurred as a result of one or more events ("loss events") that occurred after the initial recognition of investment securities available for sale. A significant or prolonged decline in the fair value of an equity security below its cost is an indicator that it is impaired. The cumulative impairment loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that asset previously recognised in profit or loss – is reclassified from other comprehensive income to profit or loss for the year. Impairment losses on equity instruments are not reversed and any subsequent gains are recognised in other comprehensive income. If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss is reversed through profit or loss for the year.

Sale and repurchase and reverse repurchase agreements. Sale and repurchase agreements ("repo agreements") which effectively provide a lender's return to the counterparty are treated as secured financing transactions. Securities sold under such sale and repurchase agreements are not derecognised. The securities are not reclassified in the statement of financial position unless the transferee has the right by contract or custom to sell or repledge the securities, in which case they are reclassified as repurchase receivables. The corresponding liability is presented within amounts due to credit institutions or other organisations.

Securities purchased under agreements to resell ("reverse repo agreements") which effectively provide a lender's return to the Bank are recorded as loans to local banks. The difference between the sale and repurchase price is treated as interest income and accrued over the life of reverse repo agreements using the effective interest method.

Investment securities held to maturity. This classification includes quoted non-derivative financial assets with fixed or determinable payments and fixed maturities that the Bank has both the intention and ability to hold to maturity. Management determines the classification of investment securities held to maturity at their initial recognition and reassesses the appropriateness of that classification at the end of each reporting period. Investment securities held to maturity are carried at amortised cost.

Premises and equipment. Premises and equipment are stated at cost less accumulated depreciation and provision for impairment, where required.

Costs of minor repairs and maintenance are expensed when incurred. Costs of replacing major parts or components of premises and equipment items are capitalised when the recognition criteria is met and the replaced part is retired.

At the end of each reporting period management assesses whether there is any indication of impairment of premises and equipment. If any such indication exists, management estimates the recoverable amount, which is determined as the higher of an asset's fair value less costs to sell and its value in use. The carrying amount is reduced to the recoverable amount and the impairment loss is recognised in profit or loss for the year. An impairment loss recognised for an asset in prior years is reversed if there has been a change in the estimates used to determine the asset's value in use or fair value less costs to sell.

Gains and losses on disposals determined by comparing proceeds with carrying amount are recognised in profit or loss for the year (within other operating income or expenses).

Depreciation. Depreciation of an asset begins when it is available for use. Land and construction in progress are not depreciated. Depreciation on other items of premises and equipment is calculated using the straight-line method to allocate their cost to their residual values over their estimated useful lives using the following rates:

	%
Buildings	3
Furniture and fixtures	20-25
Computers and office equipment	25
Motor vehicles	15

The residual value of an asset is the estimated amount that the Bank would currently obtain from disposal of the asset less the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at the end of each reporting period.

Intangible assets. The Bank's intangible assets have definite useful life and primarily include capitalised computer software and licenses.

Acquired computer software licences are capitalised on the basis of the costs incurred to acquire and bring them to use. Development costs that are directly associated with identifiable and unique software controlled by the Bank are recorded as intangible assets if an inflow of incremental economic benefits exceeding costs is probable. Capitalised costs include staff costs of the software development team and an appropriate portion of relevant overheads. All other costs associated with computer software, e.g. its maintenance, are expensed when incurred. Capitalised computer software is amortised on a straight line basis over expected useful lives of 10 years.

Operating leases. Where the Bank is a lessee in a lease which does not transfer substantially all the risks and rewards incidental to ownership from the lessor to the Bank, the total lease payments are charged to profit or loss for the year (rental expense) on a straight-line basis over the period of the lease.

Leases embedded in other agreements are separated if (a) fulfilment of the arrangement is dependent on the use of a specific asset or assets and (b) the arrangement conveys a right to use the asset.

Finance lease liabilities. Where the Bank is a lessee in a lease which transferred substantially all the risks and rewards incidental to ownership to the Bank, the assets leased are capitalised in premises and equipment at the commencement of the lease at the lower of the fair value of the leased asset and the present value of the minimum lease payments. In calculating the present value of the minimum lease payments the discount factor used is the interest rate implicit in the lease, when it is practicable to determine; otherwise, the Bank's incremental borrowing rate is used. Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate on the finance balance outstanding. The corresponding rental obligations, net of future finance charges, are included in other liabilities. The interest cost is charged to profit or loss for the year over the lease period using the effective interest method.

The assets acquired under finance leases are depreciated over their useful life or the shorter lease term if the Bank is not reasonably certain that it will obtain ownership by the end of the lease term.

Initial direct costs incurred are included as part of the asset. Lease payments are apportioned between the finance charge and the reduction of the outstanding liability. The finance charge is allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

Borrowings. Issued financial instruments or their components are classified as liabilities, where the substance of the contractual arrangement results in the Bank having an obligation either to deliver cash or another financial asset to the holder, or to satisfy the obligation other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of own equity instruments. Such instruments include amounts due to Government, amounts due to credit institutions, amounts due to other organisations, debt securities issued, funds borrowed from international financial institutions and liabilities to International Monetary Fund. These are initially recognized at fair value less directly attributable transaction costs. After initial recognition, borrowings are subsequently measured at amortised cost using the effective interest method. Gains and losses are recognised in current year profit when the borrowings are derecognised as well as through the amortisation process.

Derecognition of financial liabilities. A financial liability is derecognised when the obligation under the liability is discharged or cancelled or expires.

Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a de-recognition of the original liability and the recognition of a new liability, and the difference in the respective carrying amounts is recognised in the current year profit.

Money issued in circulation. Money issued in circulation represents banknotes and coins issued by the Bank in accordance with the Law and its function as a central bank. Banknotes and coins in circulation are recorded in the statement of financial position at their nominal value net of cash in the Bank's cash offices.

The costs of the production of notes and coins are expensed upon delivery by the suppliers to the Bank.

When notes and coins are returned to the Bank by the commercial banks they are removed from notes in circulation and depending on their condition or legal tender status, are either held under the reserve funds of the Bank off-balance sheet or destroyed.

Amounts due to credit institutions. Amounts due to credit institutions are recorded when money or other assets are advanced to the Bank by counterparty banks. The non-derivative liability is carried at amortised cost. If the Bank purchases its own debt, the liability is removed from the statement of financial position and the difference between the carrying amount of the liability and the consideration paid is included in gains or losses arising from early retirement of debt.

Amounts due to government organisations and other organisations. Amounts due to government organisations and other organisations are non-derivative liabilities and are carried at amortised cost.

Debt securities in issue. Debt securities in issue include promissory notes issued by the Bank. Debt securities are stated at amortised cost. If the Bank purchases its own debt securities in issue, they are removed from the statement of financial position and the difference between the carrying amount of the liability and the consideration paid is included in gains arising from early retirement of debt.

Derivative financial instruments. In the normal course of business, the Bank enters into derivative financial instruments such as forwards. Such financial instruments are held for trading and are recorded at fair value. The fair values are estimated based on quoted market prices or pricing models that take into account the current market and contractual prices of the underlying instruments and other factors. Derivatives are carried as assets when their fair value is positive and as liabilities when it is negative. Gains and losses resulting from these instruments are included in current year profit as gains less losses from trading securities or gains less losses from foreign currencies dealing, depending on the nature of the instrument.

Provisions for liabilities and charges. Provisions for liabilities and charges are non-financial liabilities of uncertain timing or amount. They are accrued when the Bank has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made.

Charter capital and capital reserves. The Bank's capital is comprised of its authorized paid-in capital and capital reserves. Refer to Note 22.

Income and expense recognition. Interest income and expense are recorded for all debt instruments on an accrual basis using the effective interest method. This method defers, as part of interest income or expense, all fees paid or received between the parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

Fees integral to the effective interest rate include origination fees received or paid by the entity relating to the creation or acquisition of a financial asset or issuance of a financial liability, for example fees for evaluating creditworthiness, evaluating and recording guarantees or collateral, negotiating the terms of the instrument and for processing transaction documents. Commitment fees received by the Bank to originate loans at market interest rates are integral to the effective interest rate if it is probable that the Bank will enter into a specific lending arrangement and does not expect to sell the resulting loan shortly after origination. The Bank does not designate loan commitments as financial liabilities at fair value through profit or loss.

When loans and other debt instruments become doubtful of collection, they are written down to the present value of expected cash inflows and interest income is thereafter recorded for the unwinding of the present value discount based on the asset's effective interest rate which was used to measure the impairment loss.

All other fees, commissions and other income and expense items are generally recorded on an accrual basis by reference to completion of the specific transaction assessed on the basis of the actual service provided as a proportion of the total services to be provided. Loan syndication fees are recognised as income when the syndication has been completed and the Bank retains no part of the loan package for itself or retains a part at the same effective interest rate as for the other participants.

Commissions and fees arising from negotiating, or participating in the negotiation of a transaction for a third party, such as the acquisition of loans, shares or other securities or the purchase or sale of businesses, and which are earned on execution of the underlying transaction, are recorded on its completion. Portfolio and other management advisory and service fees are recognised based on the applicable service contracts, usually on a time-proportion basis. Asset management fees related to investment funds are recorded rateably over the period the service is provided. The same principle is applied for wealth management, financial planning and custody services that are continually provided over an extended period of time.

Capitalisation of borrowing costs. Borrowing costs that are directly attributable to the acquisition, construction or production of an asset that necessarily takes a substantial period of time to get ready for its intended use or sale (a qualifying asset) form part of the cost of that asset, if the commencement date for capitalisation is on or after 1 January 2009. Other borrowing costs are recognised as an expense using the effective interest method. The Bank capitalises borrowing costs that would have been avoided if it had not made capital expenditure on qualifying assets. The commencement date for capitalisation is when (a) the Bank incurs expenditures for the qualifying asset; (b) it incurs borrowing costs; and (c) it undertakes activities that are necessary to prepare the asset for its intended use or sale. Capitalisation ceases when all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Interest or other investment income is not deducted in arriving at the amount of borrowing costs available for capitalisation, except where the Bank obtains specific borrowings for the purpose of acquiring a qualifying asset and has investment income on the temporary investment of funds obtained through such specific borrowings.

Taxation. The Bank is exempt from all taxes, except for taxes on employees' remuneration as a tax agent and social taxes, in accordance with the laws of the Republic of Azerbaijan.

Retirement and other benefit obligations. The Bank does not have any pension arrangements separate from the state pension system of Azerbaijan. In addition, the Bank has no post-retirement benefits or other significant compensation benefits requiring accrual. In accordance with the requirements of the Azerbaijan legislation, the Bank withholds amounts of pension contributions from employee salaries and pays them to the state pension fund. Upon retirement all retirement benefit payments are made by the state pension fund.

Membership in the IMF and other international financial institutions. Based on the provision of Article 9 of the Law of the Republic of Azerbaijan on the Central Bank of the Republic of Azerbaijan, the Bank acts as an intermediary of the Government of the Republic of Azerbaijan in transactions related to the membership of Azerbaijan in international financial organizations (e.g. IMF, World Bank), including payment of membership fees to such organizations.

The International Monetary Fund ("IMF") is an international organization established to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment. In accordance with the presidential decree issued in 1992, the Bank acts as a depository agent in relationships of Azerbaijan with the IMF and the role of fiscal agent is performed by the Ministry of Finance of the Republic of Azerbaijan.

Quotas (capital subscriptions) are the primary source of IMF resources. The IMF receives its resources from its member countries. Each country's subscription, or quota, is determined broadly on the basis of the economic size of the country, and taking into account quotas of similar countries. A member's quota delineates basic aspects of its financial and organizational relationship with the IMF.

Membership fees payable to IMF are denominated in Special Drawing Rights (SDR) and are revalued in AZN at the rate of exchange set by the IMF at year-end. Membership quota and securities issued by the Ministry of Finance of the Republic of Azerbaijan in respect of IMF quota are not presented in the statement of financial position as they do not represent the assets and liabilities of the Bank, but are disclosed in Note 8 to the financial statements.

General and special allocations received from the IMF to boost the liquidity of member countries are taken up by the Bank as an asset under SDR holdings with the IMF and on the other hand, as a liability to the Government of the Republic of Azerbaijan.

Contingencies. Contingent liabilities are not recognised in the statement of financial position but are disclosed unless the possibility of any outflow in settlement is remote. A contingent asset is not recognised in the statement of financial position but is disclosed when an inflow of economic benefits is probable.

Foreign currency translation. The functional and presentation currency of the Bank is the national currency of the Republic of Azerbaijan, Azerbaijani Manats ("AZN").

The financial statements are presented in Azerbaijani Manats, which is the Bank's functional and presentation currency. Transactions in foreign currencies are initially recorded in the functional currency, converted at the rate of exchange ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated at the functional currency rate of exchange ruling at the end of the reporting period. Gains and losses resulting from the translation of foreign currency transactions are recognised in current year profit or loss for the year (as foreign exchange translation gains less losses). Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the official exchange rates at the date when the fair value was determined.

Differences between the contractual exchange rate of a transaction in a foreign currency and the official rate on the date of the transaction are included in gains less losses from trading in foreign currencies.

The Bank used the following official exchange rates at 31 December 2011 and 2010 in the preparation of these financial statements:

	2011	2010
1 US Dollar	AZN 0.7865	AZN 0.7979
1 Euro	AZN 1.0178	AZN 1.0560
1 Pound sterling	AZN 1.2123	AZN 1.2377
1 Special Drawing Right	AZN 1.2037	AZN 1.2234

Fiduciary assets. Assets held by the Bank in its own name, but on the account of third parties, are not reported in the statement of financial position. Commissions received from fiduciary activities are shown in fee and commission income.

Offsetting. Financial assets and liabilities are offset and the net amount reported in the statement of financial position only when there is a legally enforceable right to offset the recognised amounts, and there is an intention to either settle on a net basis, or to realise the asset and settle the liability simultaneously.

Staff costs and related contributions. Wages, salaries, contributions to the Republic of Azerbaijan state pension and social insurance funds, paid annual leave and sick leave, bonuses, and non-monetary benefits are accrued in the year in which the associated services are rendered by the employees of the Bank. The Bank has no legal or constructive obligation to make pension or similar benefit payments beyond the payments to the State Social Security Fund under statutory defined contribution scheme.

Amendments of the financial statements after issue. The Management Board of the Bank has the power to amend the financial statements after issue.

4. Critical Accounting Estimates, and Judgements in Applying Accounting Policies

The Bank makes estimates and assumptions that affect the amounts recognised in the financial statements and the carrying amounts of assets and liabilities within the next financial year. Estimates and judgements are continually evaluated and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Management also makes certain judgements, apart from those involving estimations, in the process of applying the accounting policies. Judgements that have the most significant effect on the amounts recognised in the financial statements and estimates that can cause a significant adjustment to the carrying amount of assets and liabilities within the next financial year include:

Impairment losses on financial assets carried at amortised cost. The Bank regularly reviews its financial assets carried at amortised cost to assess impairment. In determining whether an impairment loss should be recorded in profit or loss for the year, the Bank makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of assets before the decrease can be identified with an individual asset in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience. A 10% increase or decrease in actual loss experience compared to the loss estimates used would result in an increase or decrease in loan impairment losses of AZN 596 thousand (2010: AZN 1,290 thousand), respectively. Impairment losses for individually significant loans are based on estimates of discounted future cash flows of the individual loans, taking into account repayments and realisation of any assets held as collateral against the loans. A 10% increase or decrease in the actual loss experience compared to the estimated future discounted cash flows from individually significant loans, which could arise from differences in amounts and timing of the cash flows, would result in an increase or decrease in loan impairment losses of AZN 3,810 thousand (2010: AZN 4,097 thousand), respectively.

Loans to local banks at refinancing rate. The Bank issues short and long-term loans to local banks at interest rates equal to the Bank's refinancing rate prevailing at the time of issuance and which may be lower than rates at which the local banks could ordinarily source the funds from commercial banks. Management has considered whether losses should arise on initial recognition of such instruments. As the transactions are with unrelated parties, management's judgement is that these lending activities are at the market rates and no initial recognition losses should arise. In making this judgement management also considered that these instruments are specific in nature due to their amount and terms attached and therefore, represent a separate market segment. The total carrying value of loans to local banks is disclosed in Note 10.

Impairment of held-to-maturity investments. The Bank holds investments in debt securities. Future adverse changes in market conditions or poor operating results could result in losses that may not be reflected in an investment's current carrying value, thereby requiring an impairment charge in the future. The Bank regularly reviews its investments to determine if there have been any indicators that the value may be impaired. These reviews require estimating the outcome of future events and determining whether factors exist that indicate impairment has occurred.

Fair value of financial instruments. Where the fair values of financial assets and financial liabilities recorded in the statement of financial position cannot be derived from active markets, they are determined using a variety of valuation techniques that include the use of mathematical models. The input to these models is taken from observable markets where possible, but where this is not feasible, a degree of judgment is required in establishing fair values. Refer to Note 31.

Entities not subject to consolidation. As of 31 December 2011, the Bank had two entities acting under the Bank: the Azerbaijan Mortgage Fund ("AMF") and the Financial Monitoring Service ("FMS"). These entities are not consolidated in these financial statements. While the Bank acts as supervisor of these entities as mandated by law, it has no title over their assets and liabilities, has no share ownership and rights over their economic benefits arising from their activities. The management believes that, had these two entities been consolidated to the financial statements of the Bank, total assets of the Bank at 31 December 2011 would not be different by more than 3% of current total assets (31 December 2010: 3%).

5. Adoption of New or Revised Standards and Interpretations

(a) Standards effective for annual periods beginning on or after 1 January 2011

The following new standards and interpretations became effective for the Bank from 1 January 2011

Improvements to International Financial Reporting Standards (issued in May 2010 and effective from 1 January 2011). The improvements consist of a mixture of substantive changes and clarifications in the following standards and interpretations: IFRS 1 was amended (i) to allow previous GAAP carrying value to be used as deemed cost of an item of property, plant and equipment or an intangible asset if that item was used in operations subject to rate regulation, (ii) to allow an event driven revaluation to be used as deemed cost of property, plant and equipment even if the revaluation occurs during a period covered by the first IFRS financial statements and (iii) to require a first-time adopter to explain changes in accounting policies or in the IFRS 1 exemptions between its first IFRS interim report and its first IFRS financial statements; IFRS 3 was amended (i) to require measurement at fair value (unless another measurement basis is required by other IFRS standards) of non-controlling interests that are not present ownership interest or do not entitle the holder to a proportionate share of net assets in the event of liquidation, (ii) to provide guidance on the acquiree's share-based payment arrangements that were not replaced, or were voluntarily replaced as a result of a business combination and (iii) to clarify that the contingent considerations from business combinations that occurred before the effective date of revised IFRS 3 (issued in January 2008) will be accounted for in accordance with the guidance in the previous version of IFRS 3; IFRS 7 was amended to clarify certain disclosure requirements, in particular (i) by adding an explicit emphasis on the interaction between qualitative and quantitative disclosures about the nature and extent of financial risks, (ii) by removing the requirement to disclose carrying amount of renegotiated financial assets that would otherwise be past due or impaired, (iii) by replacing the requirement to disclose fair value of collateral by a more general requirement to disclose its financial effect, and (iv) by clarifying that an entity should disclose the amount of foreclosed collateral held at the reporting date, and not the amount obtained during the reporting period; IAS 1 was amended to clarify the requirements for the presentation and content of the statement of changes in equity; IAS 27 was amended by clarifying the transition rules for amendments to IAS 21, 28 and 31 made by the revised IAS 27 (as amended in January 2008); IAS 34 was amended to add additional examples of significant events and transactions requiring disclosure in a condensed interim financial report, including transfers between the levels of fair value hierarchy, changes in classification of financial assets or changes in business or economic environment that affect the fair values of the entity's financial instruments; and IFRIC 13 was amended to clarify measurement of fair value of award credits. The above amendments resulted in additional or revised disclosures, but had no material impact on measurement or recognition of transactions and balances reported in these financial statements. The financial effect of collateral required to be disclosed by the amendments to IFRS 7 is presented in these financial statements by disclosing collateral values separately for (i) those financial assets where collateral and other credit enhancements are equal to, or exceed, carrying value of the asset ("over-collateralised assets") and (ii) those financial assets where collateral and other credit enhancements are less than the carrying value of the asset ("under-collateralised assets").

Other revised standards and interpretations effective for the current period. IFRIC 19 "Extinguishing financial liabilities with equity instruments", amendments to IAS 32 on classification of rights issues, clarifications in IFRIC 14 "IAS 19 - The limit on a defined benefit asset, minimum funding requirements and their interaction" relating to prepayments of minimum funding requirements and amendments to IFRS 1 "First-time adoption of IFRS", did not have any impact on these financial statements.

6. New Accounting Pronouncements

Certain new standards and interpretations have been issued that are mandatory for the annual periods beginning on or after 1 January 2012 or later, and which the Bank has not early adopted.

IFRS 9, Financial Instruments Part 1: Classification and Measurement. IFRS 9, issued in November 2009, replaces those parts of IAS 39 relating to the classification and measurement of financial assets. IFRS 9 was further amended in October 2010 to address the classification and measurement of financial liabilities. Key features of the standard are as follows:

- Financial assets are required to be classified into two measurement categories: those to be measured subsequently at fair value, and those to be measured subsequently at amortised cost. The decision is to be made at initial recognition. The classification depends on the entity's business model for managing its financial instruments and the contractual cash flow characteristics of the instrument.

- An instrument is subsequently measured at amortised cost only if it is a debt instrument and both (i) the objective of the entity's business model is to hold the asset to collect the contractual cash flows, and (ii) the asset's contractual cash flows represent payments of principal and interest only (that is, it has only "basic loan features"). All other debt instruments are to be measured at fair value through profit or loss.

- All equity instruments are to be measured subsequently at fair value. Equity instruments that are held for trading will be measured at fair value through profit or loss. For all other equity investments, an irrevocable election can be made at initial recognition, to recognise unrealised and realised fair value gains and losses through other comprehensive income rather than profit or loss. There is to be no recycling of fair value gains and losses to profit or loss. This election may be made on an instrument-by-instrument basis. Dividends are to be presented in profit or loss, as long as they represent a return on investment.

- Most of the requirements in IAS 39 for classification and measurement of financial liabilities were carried forward unchanged to IFRS 9. The key change is that an entity will be required to present the effects of changes in own credit risk of financial liabilities designated at fair value through profit or loss in other comprehensive income.

While adoption of IFRS 9 is mandatory from 1 January 2015, earlier adoption is permitted. The Bank is considering the implications of the standard, the impact on the Bank and the timing of its adoption by the Bank.

IFRS 10, Consolidated Financial Statements (issued in May 2011 and effective for annual periods beginning on or after 1 January 2013), replaces all of the guidance on control and consolidation in IAS 27 "Consolidated and separate financial statements" and SIC-12 "Consolidation - special purpose entities". IFRS 10 changes the definition of control so that the same criteria are applied to all entities to determine control. This definition is supported by extensive application guidance. The Bank is currently assessing the impact of the amended standard on its financial statements.

IFRS 11, Joint Arrangements, (issued in May 2011 and effective for annual periods beginning on or after 1 January 2013), replaces IAS 31 "Interests in Joint Ventures" and SIC-13 "Jointly Controlled Entities—Non-Monetary Contributions by Ventures". Changes in the definitions have reduced the number of types of joint arrangements to two: joint operations and joint ventures. The existing policy choice of proportionate consolidation for jointly controlled entities has been eliminated. Equity accounting is mandatory for participants in joint ventures. The new standard does not have any impact on these financial statements.

IFRS 12, Disclosure of Interest in Other Entities, (issued in May 2011 and effective for annual periods beginning on or after 1 January 2013), applies to entities that have an interest in a subsidiary, a joint arrangement, an associate or an unconsolidated structured entity. It replaces the disclosure requirements currently found in IAS 28 "Investments in associates". IFRS 12 requires entities to disclose information that helps financial statement readers to evaluate the nature, risks and financial effects associated with the entity's interests in subsidiaries, associates, joint arrangements and unconsolidated structured entities. To meet these objectives, the new standard requires disclosures in a number of areas, including significant judgements and assumptions made in determining whether an entity controls, jointly controls, or significantly influences its interests in other entities, extended disclosures on share of non-controlling interests in group activities and cash flows, summarised financial information of subsidiaries with material non-controlling interests, and detailed disclosures of interests in unconsolidated structured entities.

IFRS 13, Fair value measurement, (issued in May 2011 and effective for annual periods beginning on or after 1 January 2013), aims to improve consistency and reduce complexity by providing a revised definition of fair value, and a single source of fair value measurement and disclosure requirements for use across IFRSs. The Bank is currently assessing the impact of the standard on its financial statements.

IAS 27, Separate Financial Statements, (revised in May 2011 and effective for annual periods beginning on or after 1 January 2013), was changed and its objective is now to prescribe the accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity prepares separate financial statements. The guidance on control and consolidated financial statements was replaced by IFRS 10, Consolidated Financial Statements.

IAS 28, Investments in Associates and Joint Ventures, (revised in May 2011 and effective for annual periods beginning on or after 1 January 2013). The amendment of IAS 28 resulted from the Board's project on joint ventures. When discussing that project, the Board decided to incorporate the accounting for joint ventures using the equity method into IAS 28 because this method is applicable to both joint ventures and associates. With this exception, other guidance remained unchanged.

Disclosures—Transfers of Financial Assets – Amendments to IFRS 7 (issued in October 2010 and effective for annual periods beginning on or after 1 July 2011.). The amendment requires additional disclosures in respect of risk exposures arising from transferred financial assets. The amendment includes a requirement to disclose by class of asset the nature, carrying amount and a description of the risks and rewards of financial assets that have been transferred to another party, yet remain on the entity's balance sheet. Disclosures are also required to enable a user to understand the amount of any associated liabilities, and the relationship between the financial assets and associated liabilities. Where financial assets have been derecognised, but the entity is still exposed to certain risks and rewards associated with the transferred asset, additional disclosure is required to enable the effects of those risks to be understood. The Bank is currently assessing the impact of the amended standard on disclosures in its financial statements.

Amendments to IAS 1, Presentation of Financial Statements (issued June 2011, effective for annual periods beginning on or after 1 July 2012), changes the disclosure of items presented in other comprehensive income. The amendments require entities to separate items presented in other comprehensive income into two groups, based on whether or not they may be reclassified to profit or loss in the future. The suggested title used by IAS 1 has changed to 'statement of profit or loss and other comprehensive income'. The Bank expects the amended standard to change presentation of its financial statements, but have no impact on measurement of transactions and balances.

Amended IAS 19, Employee Benefits (issued in June 2011, effective for periods beginning on or after 1 January 2013), makes significant changes to the recognition and measurement of defined benefit pension expense and termination benefits, and to the disclosures for all employee benefits. The standard requires recognition of all changes in the net defined benefit liability (asset) when they occur, as follows: (i) service cost and net interest in profit or loss; and (ii) remeasurements in other comprehensive income.

Disclosures—Offsetting Financial Assets and Financial Liabilities - Amendments to IFRS 7 (issued in December 2011 and effective for annual periods beginning on or after 1 January 2013). The amendment requires disclosures that will enable users of an entity's financial statements to evaluate the effect or potential effect of netting arrangements, including rights of set-off. The amendment will have an impact on disclosures but will have no effect on measurement and recognition of financial instruments.

Offsetting Financial Assets and Financial Liabilities - Amendments to IAS 32 (issued in December 2011 and effective for annual periods beginning on or after 1 January 2014). The amendment added application guidance to IAS 32 to address inconsistencies identified in applying some of the offsetting criteria. This includes clarifying the meaning of 'currently has a legally enforceable right of set-off' and that some gross settlement systems may be considered equivalent to net settlement. The Bank is considering the implications of the amendment, the impact on the Bank and the timing of its adoption by the Bank.

Other revised standards and interpretations: The amendments to IFRS 1 "First-time adoption of IFRS", relating to severe hyperinflation and eliminating references to fixed dates for certain exceptions and exemptions, will not have any impact on these financial statements. The amendment to IAS 12 "Income taxes", which introduces a rebuttable presumption that an investment property carried at fair value is recovered entirely through sale, will not have any impact on these financial statements. IFRIC 20, Stripping Costs in the Production Phase of a Surface Mine, considers when and how to account for the benefits arising from the stripping activity in mining industry.

Unless otherwise described above, the new standards and interpretations are not expected to affect significantly the Bank's financial statements.

7. Cash and Cash Equivalents

In thousands of Azerbaijani Manats	**31/12/2011**	**31/12/2010**
Cash on hand	100,928	105,849
Placements with non-resident credit institutions	6,581,576	3,657,606
Total cash and cash equivalents	**6,682,504**	**3,763,455**

At 31 December 2011 cash and cash equivalents included AZN 6,063,233 thousand placed with two internationally recognized Organization for Economic Co-operation and Development ("OECD") banks (31 December 2010: AZN 3,335,107 thousand placed with two internationally recognized OECD banks).

The credit quality of cash and cash equivalents balances may be summarised, based on the lowest of the ratings assigned by Standard and Poor's, Fitch Ratings and Moody's, as follows at 31 December 2011:

In thousands of Azerbaijani Manats	**Current accounts with non-resident credit institutions**
Neither past due nor impaired	
- AAA rated	2,291,593
- AA- to AA+ rated	4,289,976
- A- to A+ rated	7
Total cash and cash equivalents, excluding cash on hand	**6,581,576**

An analysis by credit quality of cash and cash equivalents balances may be summarised, based on the lowest of the ratings assigned by Standard and Poor's, Fitch Ratings and Moody's, as follows at 31 December 2010:

In thousands of Azerbaijani Manats	**Current accounts with non-resident credit institutions**
Neither past due nor impaired	
- AAA rated	3,205,276
- AA- to AA+ rated	229,262
- A- to A+ rated	223,068
Total cash and cash equivalents, excluding cash on hand	**3,657,606**

Interest rate, currency and geographical analyses of cash and cash equivalents are disclosed in Note 27.

8. Balances with the International Monetary Fund

In thousands of Azerbaijani Manats	**31/12/2011**	**31/12/2010**
Assets		
Special Drawing Rights (SDR) holdings	185,029	189,638
Liabilities		
IMF current accounts	659	656
Borrowings from the IMF:		
Poverty Reduction and Growth Facility (PRGF)	22,598	37,792
SDR allocation:		
General allocation	143,630	146,038
Special allocation	41,286	41,962
Total SDR allocation	**184,916**	**188,000**
Total liabilities on transactions with the International Monetary Fund	**208,173**	**226,448**
Off-balance sheet balances:		
IMF Quota	205,674	194,538
Securities held in custody in respect of the IMF quota	(205,674)	(194,538)

SDR holdings. SDR holdings represent the current account with the IMF used for borrowings and settlements with the IMF. Interest accrued in respect of SDR holdings is calculated using the rate set by the IMF weekly on the basis of short-term market rates in major money markets. Average rate earned during 2011 was 0.40% per annum (2010: 0.29%).

IMF current accounts. The Bank maintains two separate accounts with IMF for special purposes: IMF No. 1 and IMF No. 2. IMF No. 1 account is used for paying commissions for the transactions with IMF, whereas IMF account No. 2 is used for covering expenses of the IMF representatives during their visit to member countries.

Borrowings. Borrowing from the IMF is a loan to the Government of the Republic of Azerbaijan with original maturity of ten years and bears interest 0.5% (31 December 2010: 0.5%) per annum. The borrowing is denominated in SDR and matures in 2015. The Government of the Republic of Azerbaijan has a legal obligation for the repayment of funds borrowed from the IMF that are maintained with the Bank in its depository role and the borrowing is treated by the Bank as a liability to the Government.

SDR allocation. SDR allocation is an unconditional distribution of SDR amounts to members by decision of the IMF. A general SDR allocation became effective 28 August 2009. The allocation is designed to provide liquidity to the global economic system by supplementing the IMF member countries' foreign exchange reserves. The general SDR allocation was made to IMF members in proportion to their existing IMF quotas. Separately, on 10 August 2009, the Fourth Amendment to the IMF Articles of Agreement providing for a special one-time allocation of SDRs entered into force to boost global liquidity. According to the amendment, the special allocation was made to IMF members, which includes Azerbaijan, on 9 September 2009. Members and prescribed holders may use their SDR holdings to conduct transactions with the IMF. The Bank treats the allocation as foreign exchange liability to the Government of the Republic of Azerbaijan.

IMF Quota and Securities held in custody in respect of IMF Quota. The IMF Quota, in the amount of SDR 160.9 million which has remained fixed since 25 January 1999, represents the membership subscription of the Republic of Azerbaijan with the IMF. Securities were issued by the Government of the Republic of Azerbaijan as a guarantee for this amount and are held by the Bank for the benefit of the IMF.

9. Trading Securities

In thousands of Azerbaijani Manats	**31/12/2011**	**31/12/2010**
Agency notes	729,686	96,764
US Treasury notes	260,950	165,674
Notes issued by international financial institutions Government bonds	189,223	98,310
Regional authority notes	161,200	4,015
UK Treasury notes	102,568	66,662
Government bonds	51,907	58,376
Corporate bonds	10,805	264,783
Mortgage-backed securities	-	123
Total trading securities	**1,506,339**	**754,707**

	31/12/2011		31/12/2010	
	Coupon rate	Maturity	Coupon rate	Maturity
Agency notes	0% - 5.25%	2012 - 2014	0.49% - 5.35%	2011 - 2013
US Treasury notes	0% - 3.50%	2012 - 2018	0.38% - 4.88%	2011 - 2014
Government bonds	0.50% - 6.75%	2012 - 2021	3 month LIBOR 0.05%, 0.73% - 6.50%	2011 - 2015
Notes issued by international financial institutions	0.51% - 4.50%	2013 - 2015	3 month LIBOR, 2.00% - 5.00%	2011 - 2014
Regional authority notes	0% - 0.94%	2012	0.73%	2012
UK Treasury notes	0% - 6.59%	2012 - 2021	2.25% - 9.00%	2011 - 2013
Corporate bonds	0.78% - 4.10%	2012 - 2016	0.36% - 5.25%	2011 - 2014
Mortgage-backed securities	-	-	5.50% - 6.50%	2033 - 2035

The Bank uses reputable asset managers for the management of certain of its trading securities per set investment guidelines which include the requirement that the issuers of such securities are all domiciled in OECD countries.

Agency notes are represented by US Dollar and Euro denominated notes issued by international financial agencies of Europe and USA, and were held and managed by the Bank and the external managers. US Treasury notes are US dollar denominated notes issued by the US Government and traded internationally, with semi-annual coupon payments, and were held and managed by the Bank and the external managers.

Government bonds are issued by foreign governments, and were held and managed by the Bank's external managers.

Notes issued by international financial institutions are represented by notes issued by International Bank for Reconstruction and Development and other international financial institutions and managed by the Bank and Bank's external managers.

Regional authority notes are US Dollar denominated notes issued by Canadian regional authority and were held and managed by the Bank's external managers.

UK Treasury notes are UK Sterling denominated notes issued by the UK Government and traded internationally, with semi-annual coupon payments, and were held and managed by the Bank and the external managers.

Corporate bonds are represented by US Dollar, Euro and Pound Sterling denominated bonds of financial corporations, and were held and managed by the Bank's external managers.

Trading securities are carried at fair value which also reflects any credit risk related write-downs. As trading securities are carried at their fair values based on observable market data using bid prices primarily from Bloomberg, the Bank does not analyse or monitor impairment indicators.

An analysis by credit quality of debt trading securities, based on the lowest of the ratings assigned by Standard and Poor's, Fitch Ratings and Moody's, is as follows at 31 December 2011:

In thousands of Azerbaijani Manats	Agency notes	US Treasury notes	Notes issued by international financial institutions	Regional authority notes	UK Treasury notes	Govern-ment bonds	Corporate bonds	Total
Neither past due nor impaired (at fair value)								
- AAA	719,594	-	189,223	157,258	102,568	49,259	5,300	1,223,202
- AA+	9,114	260,950	-	-	-	-	4,078	274,142
- AA	978	-	-	-	-	-	-	978
- AA-	-	-	-	3,942	-	2,544	-	6,486
- A+	-	-	-	-	-	104	-	104
- BB+	-	-	-	-	-	-	1,427	1,427
Total debt trading securities	**729,686**	**260,950**	**189,223**	**161,200**	**102,568**	**51,907**	**10,805**	**1,506,339**

An analysis by credit quality of debt trading securities, based on the lowest of the ratings assigned by Standard and Poor's, Fitch Ratings and Moody's, is as follows at 31 December 2010:

In thousands of Azerbaijani Manats	Agency notes	US Treasury notes	Notes issued by interna-tional financial institutions	Regional authority notes	UK Treasury notes	Government bonds	Corporate bonds	Mortgage-backed securities	Total
Neither past due nor impaired (at fair value)									
- AAA	93,950	165,674	98,310	-	66,662	36,822	264,783	123	726,324
- AA+	-	-	-	-	-	3,229	-	-	3,229
- AA	2,814	-	-	4,015	-	3,486	-	-	10,315
- A+	-	-	-	-	-	14,839	-	-	14,839
Total debt trading securities	**96,764**	**165,674**	**98,310**	**4,015**	**66,662**	**58,376**	**264,783**	**123**	**754,707**

Interest rate, currency, geographical and maturity analyses of trading securities are disclosed in Note 27.

10. Loans to Local Banks

In thousands of Azerbaijani Manats	31/12/2011	31/12/2010
Loans under government guarantee	1,530,817	1,362,003
Refinancing loans	578,918	558,764
Lender of last resort loans	23,646	39,210
Less: Provision for impairment	(53,222)	(47,259)
Total loans to local banks	**2,080,159**	**1,912,718**

Movements in the provision for impairment of loans to local banks are as follows:

In thousands of Azerbaijani Manats	Refinancing loans	Lender of last resort loans	Total
Provision for impairment at 1 January 2010	**25,765**	**14,241**	**40,006**
Provision for impairment during the year	6,744	6,159	12,903
Amounts written off during the year as uncollectible	(5,650)	-	(5,650)
Provision for impairment at 31 December 2010	**26,859**	**20,400**	**47,259**
Provision for impairment during the year	2,717	3,246	5,963
Provision for impairment at 31 December 2011	**29,576**	**23,646**	**53,222**

Interest income accrued on loans, for which individual impairment allowances have been recognized, as at 31 December 2011 comprised AZN 5,601 thousand (31 December 2010: AZN 4,851 thousand). In accordance with the Bank's internal regulations, loans may only be written off with the approval of the Management Board.

At 31 December 2011 the Bank had balances with seven counterparty banks (31 December 2010: seven banks) with aggregated loan amounts above AZN 50,000 thousand. The total aggregate amount of these loans was AZN 1,818,315 thousand (31 December 2010: AZN 1,735,342 thousand) or 86% of the total amount of loans to local banks (31 December 2010: 88%). Included in these loans were AZN 1,530,817 thousand (31 December 2010: AZN 1,362,003 thousand) issued to a state controlled and several commercial banks which were further on-lent to state entities for financing of large scale infrastructural projects implemented by the Government of Azerbaijan. These loans were effectively collateralized by the guarantee letters received from Ministry of Finance of the Republic of Azerbaijan.

At 31 December 2011 the Bank had a concentration in its loans represented by AZN 964,387 thousand due from the largest single borrower (45% of gross loan portfolio) (31 December 2010: due from the largest single borrower - AZN 1,045,371 thousand or 53% of gross loan portfolio).

Information about collateral at 31 December 2011 is as follows:

In thousands of Azerbaijani Manats	Loans under government guarantee	Refinancing loans	Lender of last resort loans	Total
Unsecured loans	-	87,839	-	87,839
Loans collateralised by:				
- residential real estate	-	32,303	-	32,303
- other real estate	-	428,368	-	428,368
- tradable securities	-	832	-	832
- guarantee letters from government	1,530,817	-	-	1,530,817
Total loans to local banks	**1,530,817**	**549,342**	**-**	**2,080,159**

Information about collateral at 31 December 2010 is as follows:

In thousands of Azerbaijani Manats	Loans under government guarantee	Refinancing loans	Lender of last resort loans	Total
Unsecured loans	-	90,852	-	90,852
Loans collateralised by:				
- residential real estate	-	40,370	556	40,926
- other real estate	-	391,284	18,254	409,538
- tradable securities	-	9,399	-	9,399
- guarantee letters from government	1,362,003	-	-	1,362,003
Total loans to local banks	**1,362,003**	**531,905**	**18,810**	**1,912,718**

The disclosure above represents the lower of the carrying value of the loan or collateral taken; the remaining part is disclosed within the unsecured exposures. The carrying value of loans was allocated based on liquidity of the assets taken as collateral.

The amount and type of collateral required depends on an assessment of the credit risk of the counterparty. Guidelines are implemented regarding the acceptability of types of collateral and valuation parameters. The main types of collateral obtained are residential property and other types of which include land, plants, office buildings and shops. Management monitors the market value of collateral, requests additional collateral in accordance with the underlying agreement, and monitors the market value of collateral obtained during its review of the adequacy of the allowance for loan impairment.

An analysis by credit quality of loans to local banks outstanding at 31 December 2011 is as follows:

In thousands of Azerbaijani Manats	Loans under government guarantee	Refinancing loans	Lender of last resort loans	Total
Neither past due nor impaired				
- Top 20 Azerbaijani banks	1,082,195	426,454	-	1,508,649
- Other banks	448,622	133,535	-	582,157
Total neither past due nor impaired	**1,530,817**	**559,989**	**-**	**2,090,806**
Balances individually determined to be impaired (gross)				
- 91 to 180 days overdue	-	1,218	-	1,218
- 181 to 360 days overdue	-	6,136	-	6,136
- over 360 days overdue	-	11,575	23,646	35,221
Total individually impaired (gross)	**-**	**18,929**	**23,646**	**42,575**
Less provision for impairment	**-**	**(29,576)**	**(23,646)**	**(53,222)**
Total loans to local banks	**1,530,817**	**549,342**	**-**	**2,080,159**

An analysis by credit quality of loans to local banks outstanding at 31 December 2010 is as follows:

In thousands of Azerbaijani Manats	Loans under government guarantee	Refinancing loans	Lender of last resort loans	Total
Neither past due nor impaired				
- Top 20 Azerbaijani banks	1,064,405	438,069	19,000	1,521,474
- Other banks	297,598	90,696	-	388,294
Total neither past due nor impaired	**1,362,003**	**528,765**	**19,000**	**1,909,768**
Balances individually determined to be impaired (gross)				
- less than 30 days overdue	-	7,443	-	7,443
- 30 to 90 days overdue	-	800	20,210	21,010
- 91 to 180 days overdue	-	1,166	-	1,166
- 181 to 360 days overdue	-	9,923	-	9,923
- over 360 days overdue	-	10,667	-	10,667
Total individually impaired (gross)	**-**	**29,999**	**20,210**	**50,209**
Less provision for impairment	**-**	**(26,859)**	**(20,400)**	**(47,259)**
Total loans to local banks	**1,362,003**	**531,905**	**18,810**	**1,912,718**

The Bank applied the portfolio provisioning methodology prescribed by IAS 39, Financial Instruments: Recognition and Measurement, and created portfolio provisions for impairment losses that were incurred but have not been specifically identified with any individual loan by the end of the reporting period. The Bank's policy is to classify each loan as 'neither past due nor impaired' until specific objective evidence of impairment of the loan is identified. The impairment provisions may exceed the total gross amount of individually impaired loans as a result of this policy and the portfolio impairment methodology.

The primary factors that the Bank considers in determining whether a loan is impaired are its overdue status and realisability of related collateral, if any. As a result, the Bank presents above an ageing analysis of loans that are individually determined to be impaired.

The financial effect of collateral is presented by disclosing collateral values separately for (i) those assets where collateral and other credit enhancements are equal to or exceed carrying value of the asset ("over-collateralised assets") and (ii) those assets where collateral and other credit enhancements are less than the carrying value of the asset ("under-collateralised assets"). The effect of collateral at 31 December 2011:

In thousands of Azerbaijani Manats	Over-collateralised Assets		Under-collateralised Assets	
	Carrying value of the assets	Fair value of collateral	Carrying value of the assets	Fair value of collateral
Loans under government guarantee	1,530,817	1,530,817	-	-
Refinancing loans	461,148	1,125,701	88,185	-

The effect of collateral at 31 December 2010:

In thousands of Azerbaijani Manats	Over-collateralised Assets		Under-collateralised Assets	
	Carrying value of the assets	Fair value of collateral	Carrying value of the assets	Fair value of collateral
Loans under government guarantee	1,362,003	1,362,003	-	-
Refinancing loans	446,899	1,002,559	85,007	-
Lender of last resort loans	-	-	18,810	-

Refer to Note 31 for the estimated fair value of each class of loans to local banks. Interest rate, currency, geographical and maturity analyses of loans to local banks are disclosed in Note 27. Information on related party balances is disclosed in Note 33.

11. Investment Securities

In thousands of Azerbaijani Manats	31/12/2011	31/12/2010
Loans and advances:		
Bonds issued by the Ministry of Finance of the Republic of Azerbaijan	128,253	134,293
Held-to-maturity investments:	**197,521**	**852,944**
US Treasury bills	197,521	119,699
UK Treasury bills	-	238,260
France government Treasury bills	-	137,077
International Bank for Reconstruction and Development	-	119,778
Italy government Treasury bills	-	61,569
Germany government Treasury bills	-	52,727
BMT Nordic Investment Bank	-	41,041
Germany State Agency KWF	-	27,412
France State Agency SFE	-	24,153
Spain government Treasury bills	-	20,488
German Regional State	-	10,740
Investments available-for-sale:		
Bonds issued by the Ministry of Finance of the Republic of Azerbaijan	40,004	40,004
Azerbaijan Mortgage Fund	-	23,160
Less: Provision for impairment	(4,295)	(4,295)
Total investment securities	**361,483**	**1,046,106**

A comparison of nominal and carrying values of investment securities is as follows:

In thousands of Azerbaijani Manats	31/12/2011		31/12/2010	
	Carrying value	Nominal value	Carrying value	Nominal value
Loans and advances:				
Bonds issued by the Ministry of Finance of the Republic of Azerbaijan	128,253	123,760	134,293	129,840
Held-to-maturity investments:	**197,521**	**196,625**	**852,944**	**833,758**
US Treasury bills	197,521	196,625	119,699	119,685
UK Treasury bills	-	-	238,260	223,925
France government Treasury bills	-	-	137,077	137,280
International Bank for Reconstruction and Development	-	-	119,778	119,685
Italy government Treasury bills	-	-	61,569	59,843
Germany government Treasury bills	-	-	52,727	52,800
BMT Nordic Investment Bank	-	-	41,041	39,895
Germany State Agency KWF	-	-	27,412	26,400
France State Agency SFE	-	-	24,153	23,937
Spain government Treasury bills	-	-	20,488	19,948
German Regional State	-	-	10,740	10,360
Investments available for sale:				
Bonds issued by the Ministry of Finance of the Republic of Azerbaijan	40,004	40,004	40,004	40,004
Azerbaijan Mortgage Fund	-	-	23,160	22,694
Investment securities (gross)	**365,778**	**360,389**	**1,050,401**	**1,026,296**
Less: Provision for impairment	(4,295)	-	(4,295)	-
Investment securities (net)	**361,483**	**360,389**	**1,046,106**	**1,026,296**

Nominal interest rates and maturities of these securities are as follows:

	31/12/2011		31/12/2010	
	Coupon rate	Maturity	Coupon rate	Maturity
Loans and advances:				
Bonds issued by the Ministry of Finance of the Republic of Azerbaijan	0.15% - 0.30%	2021 - 2023	0.15% - 0.30%	2021 - 2023
Investments held to maturity:				
US Treasury bills	0.38% - 1.38%	2012	0% - 0.88%	2011
UK Treasury bills	-	-	0% - 5.13%	2011
France government Treasury bills	-	-	0.56% - 0.63%	2011
International Bank for Reconstruction and Development	-	-	0.85%	2011
Italy government Treasury bills	-	-	6.00%	2011
Germany government Treasury bills	-	-	0.56%	2011
BMT Nordic Investment Bank	-	-	3.88%	2011
Germany State Agency KWF	-	-	4.00%	2011
France State Agency SFE	-	-	2.00%	2011
Spain government Treasury bills	-	-	3.38%	2011
German Regional State	-	-	4.13%	2011
Investments available for sale:				
Bonds issued by the Ministry of Finance of the Republic of Azerbaijan	2.00%	2015	2.00%	2015
Azerbaijan Mortgage Fund	-	-	3.00% - 3.25%	2019

At 31 December 2011, investment securities were represented by the following fixed income and discount securities:

Bonds issued by the Ministry of Finance of the Republic of Azerbaijan are AZN denominated:

- Securities issued with annual effective interest rate of 0.30% (31 December 2010: 0.30%) maturing in 2021 (31 December 2010: 2021). These securities were issued for repayment of debts on centralized loans of Rural Investment Joint Stock Company during 2001;
- Securities issued with annual effective interest rate of 0.15% (31 December 2010: 0.15%) maturing in 2023 (31 December 2010: 2023). These securities were issued to finance loans previously provided to cover the budget deficits during 1992 – 1996; and
- Securities issued with annual effective interest rate of 2.00% maturing in 2015. These securities were purchased during the year ended 31 December 2010. These securities were issued by the Ministry of Finance to finance infrastructural projects.

US Treasury bills are US Dollar denominated bills issued by the US Government and traded internationally. These treasury bills are held and managed by the Bank and by the external managers.

An analysis by credit quality of investment securities classified at 31 December 2011 is as follows:

In thousands of Azerbaijani Manats	**Bonds issued by the Ministry of Finance of the Republic of Azerbaijan**	**US Treasury bills**	**Total**
Neither past due nor impaired			
- A- to A+ rated	-	197,521	197,521
- BBB- rated	163,962	-	163,962
Total neither past due nor impaired	**163,962**	**197,521**	**361,483**
- over 360 days overdue	4,295	-	4,295
Less provision for impairment	**(4,295)**	**-**	**(4,295)**
Total debt securities	**163,962**	**197,521**	**361,483**

The credit quality information provided in the above table is based on the lowest of the ratings assigned by Standard and Poor's, Fitch Ratings and Moody's.

An analysis by credit quality of investment securities classified at 31 December 2010 is as follows:

In thousands of Azerbaijani Manats	Bonds issued by the Ministry of Finance of the Republic of Azerbaijan	UK Treasury bills	France government Treasury bills	IBRD	US Treasury bills	Italy government Treasury bills	Germany government Treasury bills	BMT Nordic Investment Bank	Germany State Agency KWF	France State Agency SFE	Spain government Treasury bills	German Regional State	Azerbaijan Mortgage Fund	Total
Neither past due nor impaired														
- AAA rated	-	238,260	137,077	119,778	119,699	-	52,727	41,041	27,412	24,153	20,488	10,740	-	791,375
- A- to A+ rated	-	-	-	-	-	61,569	-	-	-	-	-	-	-	61,569
- BBB- rated	-	-	-	-	-	-	-	-	-	-	-	-	23,160	23,160
- BB+ rated	170,002	-	-	-	-	-	-	-	-	-	-	-	-	170,002
Total neither past due nor impaired	**170,002**	**238,260**	**137,077**	**119,778**	**119,699**	**61,569**	**52,727**	**41,041**	**27,412**	**24,153**	**20,488**	**10,740**	**23,160**	**1,046,106**
- over 360 days overdue	4,295	-	-	-	-	-	-	-	-	-	-	-	-	4,295
Less provision for impairment	**(4,295)**	-	-	-	-	-	-	-	-	-	-	-	-	**(4,295)**
Total debt securities	**170,002**	**238,260**	**137,077**	**119,778**	**119,699**	**61,569**	**52,727**	**41,041**	**27,412**	**24,153**	**20,488**	**10,740**	**23,160**	**1,046,106**

Refer to Note 31 for the disclosure of the fair value of each class of investment securities. Interest rate, currency, geographical and maturity analyses of investment securities are disclosed in Note 27.

Information on related party investment securities is disclosed in Note 33.

12. Premises, Equipment and Intangible Assets

In thousands of Azerbaijani Manats	Note	Land	Buildings	Furniture and fixtures	Computers and office equipment	Motor vehicles	Assets under construction	Total
Carrying amount at 1 January 2010		-	**15,536**	**7,246**	**1,469**	**631**	-	**24,882**
Additions		5,513	123	1,001	1,588	58	5,810	14,093
Disposals at cost		-	-	(47)	(186)	(12)	-	(245)
Accumulated depreciation of disposals		-	-	47	186	12	-	245
Depreciation charge	26	-	(737)	(3,124)	(991)	(176)	-	(5,028)
Carrying amount at 31 December 2010		**5,513**	**14,922**	**5,123**	**2,066**	**513**	**5,810**	**33,947**
Cost at 31 December 2010		5,513	24,168	30,806	6,460	1,790	5,810	74,547
Accumulated depreciation		-	(9,246)	(25,683)	(4,394)	(1,277)	-	(40,600)
Carrying amount at 31 December 2010		**5,513**	**14,922**	**5,123**	**2,066**	**513**	**5,810**	**33,947**
Additions		10,213	252	384	766	191	-	11,806
Disposals at cost		-	(33)	(148)	(155)	(55)	-	(391)
Accumulated depreciation of disposals		-	15	146	153	55	-	369
Depreciation charge	26	-	(693)	(3,061)	(731)	(269)	-	(4,754)
Carrying amount at 31 December 2011		**15,726**	**14,463**	**2,444**	**2,099**	**435**	**5,810**	**40,977**
Cost at 31 December 2011		15,726	24,387	31,044	7,069	1,926	5,810	85,962
Accumulated depreciation		-	(9,924)	(28,600)	(4,970)	(1,491)	-	(44,985)
Carrying amount at 31 December 2011		**15,726**	**14,463**	**2,444**	**2,099**	**435**	**5,810**	**40,977**

Construction in progress consists of construction of premises and equipment for regional offices. Upon completion, assets are transferred to premises and equipment.

The movements in intangible assets which comprised acquired computer software and licenses were as follows:

	Note	2011	2010
Cost:			
1 January		**14,977**	**11,541**
Additions		2,335	3,436
31 December		**17,312**	**14,977**
Accumulated amortization:			
1 January		**(6,349)**	**(5,125)**
Amortisation charge	26	(1,346)	(1,224)
31 December		**(7,695)**	**(6,349)**
Carrying amount:			
1 January		**8,628**	**6,416**
31 December		**9,617**	**8,628**

13. Other Financial Assets

In thousands of Azerbaijani Manats	Note	31/12/2011	31/12/2010
Foreign exchange forward contracts	30	2,133	117
Loans to employees		1,621	1,748
Advances received for foreign currency dealing operations		154	228
Receivables for investments disposed		-	2,785
Other debtors		77	1,001
Less: Provision for impairment		(20)	(35)
Total other financial assets		**3,965**	**5,844**

An analysis by credit quality of other financial assets outstanding at 31 December 2011 is as follows:

In thousands of Azerbaijani Manats	Loans to employees	Advances received for foreign currency dealing operations	Foreign exchange forward contracts	Other debtors	Total
Neither past due nor impaired					
- Collected or settled after the end of the reporting period	-	154	2,133	77	2,364
- Loans guaranteed by salaries	1,621	-	-	-	1,621
Total neither past due nor impaired	**1,621**	**154**	**2,133**	**77**	**3,985**
Less provision for impairment	**(20)**	**-**	**-**	**-**	**(20)**
Total other financial assets	**1,601**	**154**	**2,133**	**77**	**3,965**

An analysis by credit quality of other financial assets outstanding at 31 December 2010 is as follows:

In thousands of Azerbaijani Manats	Receivables for investments disposed	Loans to employees	Advances received for foreign currency dealing operations	Foreign exchange forward contracts	Other debtors	Total
Neither past due nor impaired						
- Collected or settled after the end of the reporting period	2,785	-	228	117	1,001	4,131
- Loans guaranteed by salaries	-	1,748	-	-	-	1,748
Total neither past due nor impaired	**2,785**	**1,748**	**228**	**117**	**1,001**	**5,879**
Less provision for impairment	**-**	**(35)**	**-**	**-**	**-**	**(35)**
Total other financial assets	**2,785**	**1,713**	**228**	**117**	**1,001**	**5,844**

Refer to Note 31 for the disclosure of the fair value of each class of other financial assets. Currency, geographical and maturity analyses of other financial assets are disclosed in Note 27. Information on related party balances is disclosed in Note 33.

14. Other Assets

In thousands of Azerbaijani Manats	31/12/2011	31/12/2010
Prepayments to suppliers	46,433	45,370
Total other assets	**46,433**	**45,370**
Current	30,104	39,917
Non-current	16,329	5,453

At 31 December 2011, the balance of prepayments to suppliers included total of AZN 40,074 thousand (31 December 2010: AZN 30,005 thousand) paid for the construction of the Bank's new office building, regional branches and buildings intended to be used for other purposes, also AZN 4,976 thousand (31 December 2010: AZN 11,470 thousand) paid for the production of banknotes and coins.

Information on related party balances is disclosed in Note 33.

15. Money Issued in Circulation

Money issued in circulation represents the amount of national currency of the Republic of Azerbaijan issued by the Bank. This comprises the Azerbaijani Manat issued into circulation from 1 January 2006, and old Azerbaijani Manat ("AZM") issued into circulation since the introduction of the national currency in 1992. The Azerbaijani Manat was denominated on 1 January 2006 and, starting from that date, AZM 5,000 is equal to 1 AZN.

During the year ended 31 December 2011 the Bank accepted new banknotes amounting to AZN 225,380 thousand from the printing company (2010: AZN 50,000 thousand).

In thousands of Azerbaijani Manats	2011	2010
1 January	**5,793,219**	**4,512,710**
Banknotes issued into circulation	1,860,614	1,278,349
Old banknotes withdrawn from circulation	(53)	(49)
Commemorative coins issued in circulation	205	-
New coins issued into circulation	4,501	2,209
31 December	**7,658,486**	**5,793,219**

16. Amounts Due to Credit Institutions

Amounts due to credit institutions comprise the following:

In thousands of Azerbaijani Manats	31/12/2011	31/12/2010
Current accounts	725,701	704,681
Obligatory reserves	100,726	20,860
Repurchase transactions	40,934	5,775
Blocked accounts	336	1,589
Amounts due to credit institutions	**867,697**	**732,905**

Included in current accounts and obligatory reserves is a balance of AZN 472,042 thousand (31 December 2010: AZN 407,008 thousand) with five largest local banks (31 December 2010: with five largest local banks).

Obligatory reserves represent legal reserves required of credit institutions to be maintained with the Bank, and are calculated as 3% (31 December 2010: 0.5%) of the bank's eligible liabilities to customers. Current accounts and obligatory reserves are non interest-bearing.

At 31 December 2011, repurchase transactions represented agreements with commercial banks for short-term notes.

Refer to Note 31 for the disclosure of the fair value of each class of amounts due to credit institutions. Interest rate, currency, geographical and maturity analysis of amounts due to credit institutions are disclosed in Note 27. Information on related party balances is disclosed in Note 33.

17. Amounts Due to Government Organizations

Amounts due to government organizations consist of the following

In thousands of Azerbaijani Manats	31/12/2011	31/12/2010
Amounts due to the Central Treasury of the Republic of Azerbaijan	2,360,519	1,140,700
Amounts due to the State Oil Fund of the Republic of Azerbaijan	133,919	71,056
Other demand deposits	8,786	42,456
Amounts due to government organizations	**2,503,224**	**1,254,212**

Amounts due to the State Oil Fund of the Republic of Azerbaijan were placed with the Federal Reserve Bank of New York with interest rate based on the Federal Reserve rate.

Interest rate, currency, geographical and maturity analysis of amounts due to government organisations are disclosed in Note 27.

18. Amounts Due to Other Organisations

In thousands of Azerbaijani Manats	31/12/2011	31/12/2010
Public organisations	4,473	1,347
Other financial institutions	186	250
Other	19	807
Amounts due to other organisations	**4,678**	**2,404**

Refer to Note 31 for the disclosure of the fair value of each class of amounts due to other organisations. Interest rate, currency, geographical and maturity analysis of amounts due to other organisations are disclosed in Note 27.

Information on related party balances disclosed in Note 33.

19. Debt Securities in Issue

In thousands of Azerbaijani Manats	31/12/2011	31/12/2010
Short-term notes	50,185	34,193
Total debt securities in issue	**50,185**	**34,193**

Information about short-term notes is as follows:

	Interest rate p.a.	Maturity	Nominal value	Carrying value	Market price, % of nominal value
31 December 2011	2.79% - 2.99%	7 January - 28 January, 2012	50,335	50,185	99.77% - 99.79%
31 December 2010	1.42% - 2.16%	January 5 - January 26, 2011	34,218	34,193	99.83% - 99.89%

Refer to Note 31 for the disclosure of the fair value of each class of debt securities in issue. Interest rate, currency, geographical and maturity analysis of debt securities in issue are disclosed in Note 27.

20. Amounts Due to International Financial Institutions

In thousands of Azerbaijani Manats	31/12/2011	31/12/2010
Borrowings from International Development Association (IDA)	3,591	4,019
Amounts due to other international financial institutions	178	98
Total amounts due to international financial institutions	**3,769**	**4,117**

Borrowings from IDA are loans with original maturity of 19 years and bear interest of 1.0% (2010: 1.0%) per annum. The IDA loans are received from the Ministry of Finance of Azerbaijan through a secondary agreement. The repayment of the first loan commenced in 2005, the second loan in 2007 on a semi-annual basis for the amount of USD 85 thousand and USD 149 thousand per period, respectively. The repayment of the third loan has not started yet. The loans are denominated in US Dollars. First and second loans will be fully repaid by 2021.

Refer to Note 31 for disclosure of the fair value of each class of amounts due to international financial institutions. Interest rate, currency, geographical and maturity analysis of amounts due to international financial institutions are disclosed in Note 27.

21. Other Financial Liabilities

In thousands of Azerbaijani Manats	Note	31/12/2011	31/12/2010
Advances received for the purchase of foreign currency		636	222
Amounts payable for investments securities purchased		588	3,619
Amounts in the course of settlement		581	139
Foreign exchange forward contracts	30	345	1,437
Total other financial liabilities		**2,150**	**5,417**

Refer to Note 31 for disclosure of the fair value of each class of other financial liabilities.

22. Equity

The authorized and fully paid capital of the Bank is AZN 10,000 thousand. During the year ended 31 December 2009, the Ministry of Finance of the Republic of Azerbaijan contributed an additional capital to the Bank by issuing non-interest bearing promissory notes with the nominal amount of AZN 255,400 thousand with maturity in 2019. The purpose of this contribution was to cover the capital deficit of the Bank in the amount of AZN 255,399 thousand which occurred further to losses amounting to AZN 402,155 thousand arising in 2008 from the revaluation of foreign currency position of the Bank due to the appreciation of Azerbaijani Manat against foreign currencies. The notes were initially recognised at the fair value of AZN 209,517 thousand with the corresponding increase in capital reserves.

In accordance with Article 14 of the Law on the Central Bank of Azerbaijan (the “Law”), the Bank cannot be declared bankrupt and any deficit in capital is to be covered by the State. At 31 December 2011, the Bank had a capital deficit of AZN 160,784 thousand (31 December 2010: AZN 76,134 thousand). The Management Board expects that during the year ending 31 December 2012 the Ministry of Finance of Azerbaijan will make a capital contribution in accordance with the Article 14 of the Law. This expected contribution has already been built into the State budget for 2012. The management considered whether any receivable from the State should be recognised in these financial statements for the expected capital contribution as at 31 December 2011 and 31 December 2010 and concluded that due to the absence of the determined form and time frame of the capital contribution, criteria for the recognition of an asset with respect to the expected capital contribution were not met. Refer to Note 28.

23. Interest Income and Expense

In thousands of Azerbaijani Manats	2011	2010
Interest income		
Loans to local banks	63,870	43,459
Trading securities	20,866	21,566
Placements with non-resident credit institutions	17,026	8,558
Promissory note from the government	4,624	4,635
Investment securities held-to-maturity	4,054	4,499
Investments securities available for sale	431	331
Other	881	671
Total interest income	**111,752**	**83,719**
Interest expense		
Debt securities issued	1,161	212
Liabilities on transactions with the International Monetary Fund	918	763
Amounts due to international financial institutions	37	41
Amounts due to government organisations	2	12
Total interest expense	**2,118**	**1,028**
Net interest income	**109,634**	**82,691**

Interest income includes AZN 977 thousand (2010: AZN 598 thousand) interest income recognised on impaired loans to local banks.

24. Fee and Commission Income and Expense

In thousands of Azerbaijani Manats	2011	2010
Fee and commission income		
Fee and commission income not relating to financial instruments at fair value through profit or loss:		
- Currency conversion operations	4,628	2,032
- Settlements operations	3,195	3,012
- Cash operations	57	84
- Cash collections and transportation	4	3
Total fee and commission income	**7,884**	**5,131**
Fee and commission expense		
Fee and commission expense not relating to financial instruments at fair value through profit or loss		
- Securities operations	657	747
- Settlements operations	47	43
- Currency conversion operations	20	1,217
- Cash operations	-	2
Total fee and commission expense	**724**	**2,009**
Net fee and commission income	**7,160**	**3,122**

Securities operations is primarily comprised of fees incurred in relation to external asset managers' services in managing certain of the Bank's investment portfolios under the Asset Management Agreements entered into by the Bank with three external asset managers.

The Bank involved external asset managers to manage a certain volume of the Bank's foreign currency denominated assets and appointed them as its agents and delegated them to manage the investment and reinvestment of certain monies and assets which are deposited from time to time by the Bank. The Bank entered into a Custodian Agreement with a leading foreign bank specialized in this area to serve as the Custodian of the investment portfolios. The funds and assets are held at the third party Custodian, which monitors portfolios and is provided by the Bank the authority to release or deliver securities of the portfolio, register securities, and conduct transactions based on the asset manager's requests on buy/sell decisions. The Custodian provides the Bank a monthly report of all monies received in respect of the portfolio or paid out of the portfolio. Investment emphasis is on high-quality instruments with a high degree of marketability and liquidity. A minimum credit quality of AA- by Standard & Poor's (or Aa3 by Moody's) is a benchmark for these investments. The assets placed with external managers can be recalled by the Bank upon 30 days' written notice in advance.

The external asset managers, acting as agents, have complete discretion but within the set of investment guidelines prescribed by the Bank, for the account of the Bank to buy, sell or otherwise deal in investment securities and other assets, make deposits, subscribe to issues and offers for sale, and accept placements, underwritings and sub-underwritings, of any investments, advise on or execute transactions in unregulated collective investment schemes, effect transactions in markets identified in investment guidelines, negotiate and execute counterparty and account opening documentation, take all day to day decisions and otherwise act as the external managers judge appropriate in relation to the management of the funds.

25. Other Income

In thousands of Azerbaijani Manats	2011	2010
Income from central credit register system	922	487
Income from sales of commemorative coins	534	827
Other	193	143
Total other income	**1,649**	**1,457**

26. Administrative and Other Operating Expenses

In thousands of Azerbaijani Manats	Note	2011	2010
Staff costs		13,718	12,021
Regional construction and social expenses		11,277	259
Bank notes and coins production and transportation expenses		10,172	5,115
Depreciation of premises and equipment	12	4,754	5,028
Expenses related to financing of Financial Monitoring Service		3,350	1,658
Amortisation of software and other intangible assets	12	1,346	1,224
Security		1,147	1,334
Communications		534	550
Software maintenance fees		474	482
Repairs and maintenance of property and equipment		410	365
Office supplies		370	420
Heating and lighting		254	248
Insurance		229	236
Business travel and related		180	185
Occupancy and rent		141	34
Legal and consultancy		140	68
Printing		98	87
Utilities		40	34
Other		1,495	1,705
Total administrative and other operating expenses		**50,129**	**31,053**

Included in staff costs are statutory pension contributions of AZN 2,348 thousand (2010: AZN 2,059 thousand).

27. Financial Risk Management

The activities of the Bank are exposed to various risks. Risk management therefore is a critical component of its banking activities. Risk is inherent in the Bank's activities but it is managed through a process of ongoing identification, measurement and daily monitoring, subject to risk limits and other controls. At certain times, the Bank may be overly exposed to certain risks and/or take disadvantageous positions in fulfilling its responsibilities, which are typical for central banks and consequently incur unexpected financial losses, e.g. losses from translation of foreign currency balances.

Each individual within the Bank is accountable for the risk exposures relating to his or her responsibilities. The Bank is exposed to credit risk, liquidity risk and market risk. It is also subject to operating risks.

The independent risk control process does not include business risks such as changes in the environment, technology and industry. They are monitored through the Bank's strategic planning process.

The Management Board is ultimately responsible for identifying and controlling risks; however, there are separate business units responsible for managing and monitoring the various risks:

Management Board. The Management Board is responsible for the overall risk management approach, risk tolerance levels and for approving the main principles of risk management.

Investment Committee. The Investment Committee is responsible for defining the acceptable limits for management of the Bank's foreign currency assets in accordance with the "Regulations for Management of Foreign Currency Assets of the Central Bank of the Republic of Azerbaijan".

Risk Management Unit. The Risk Management Unit of the Market Operations Department permanently controls the limits set for management of foreign currency assets in accordance with the “Regulations for Management of Foreign Currency Assets of the Central Bank of the Republic of Azerbaijan”, “Main Directions for Management of Foreign Currency Assets of the Central Bank of the Republic of Azerbaijan”, and “Operational Investment Strategy for Management of Foreign Currency Assets of the Central Bank of the Republic of Azerbaijan”.

Internal Audit. Risk management processes throughout the Bank are audited annually by the Internal Audit that examines both the adequacy of the procedures and the Bank’s compliance with the procedures. Internal Audit discusses the results of all assessments with management, and reports its findings and recommendations to the Chairman of the Bank.

Risk measurement and reporting systems. Depending on the structure of operations, the risk management in the Bank is conducted by centralized and non-centralized methods. Financial risk management is conducted centrally whereas operational risk management is not centralized.

Operations are allocated among members of the Management Board based on control principle. Each Board member must control the operations under his sector of responsibility.

Risk management is conducted directly by various departments. There are also special committees and commissions within the Bank for conducting operations and control such as the Investment Committee, Credit Committee, and Regular Commission on determination of official exchange rates of the Bank, and others.

The risk related to the Bank’s foreign currency assets is a significant risk. Segregation of duties, procedures and reporting for risk management are regulated by the “Guidelines on Management of Foreign Currency Assets of the Central Bank of the Republic of Azerbaijan”. Acceptable limits on managed risks are stipulated in the “Guidelines on Management of Foreign Currency Assets of the Central Bank of the Republic of Azerbaijan”, “Main Directions of Management of Foreign Currency Assets of the Central Bank of the Republic of Azerbaijan”, “Operational Investment Strategy for Management of Foreign Currency Assets of the Central Bank of the Republic of Azerbaijan” and “Investment Rules for Management of Assets by Foreign Managers”. These limits are defined by the Investment Committee and approved by the Management Board. Ongoing control over risks is exercised by Risk Management Division of the Market Operations Department and Financial Market Operations Division of the Payment Systems and Settlements Department.

Operational risks management is conducted by the Management Board and the Internal Audit Department. The Management Board approves operational procedures and guidelines for limitation of operational risk. The Internal Audit Department regularly monitors and reports to the Management Board on the implementation of operational procedures.

Excessive risk concentration. Concentrations arise when a number of counterparties are engaged in similar business activities, or activities in the same geographic region, or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Concentrations indicate the relative sensitivity of the Bank’s performance to developments affecting a particular industry or geographical location.

In order to avoid excessive concentrations of risks, the Bank’s policies and procedures include specific guidelines to focus on maintaining a diversified portfolio.

Credit risk. The Bank is exposed to credit risk, which is the risk that one party will incur a loss because the other party failed to comply with its financial obligations. Exposure to credit risk arises as a result of the Bank’s lending and other transactions with counterparties giving rise to financial assets. Credit risk is managed and controlled through proper selection of investment assets, credit quality of investment assets and setting limits on the amount of investment per investment asset.

The Bank structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, or groups of borrowers, and to geographical and industry segments. Limits on the level of credit risk by product and industry sector are approved regularly by management. Such risks are monitored on a revolving basis and subject to an annual or more frequent review.

In accordance with the investment guidelines of the Bank, only investment instruments with short-term ratings of not less than A-1+ (Standard & Poor's), F-1 (Fitch) or P-1 (Moody's) and long-term ratings of not less than AA- (Standard & Poor's, Fitch) or Aa3 (Moody's) may be used for management of the Bank's assets. At the same time, the maximum amount invested in one commercial bank is defined as the equivalent of US Dollar 100 million. Subject to the terms of the investment instrument, minimal credit rating is defined as A+ (Standard & Poor's, Fitch) for investment instruments with a term of up to 1 month, AA- (Standard & Poor's, Fitch) for deposits with a term from one to six months, and AA+ (Standard & Poor's, Fitch) for deposits with a term over six months. When different credit ratings are designated by the various agencies, the rating meeting the minimum required level for this asset is used.

The Bank classifies loans based on a credit rating system. This provides early identification of possible changes in the creditworthiness of counterparties. Credit rating allows the Bank to assess the potential loss as a result of the risks to which the Bank is exposed and take corrective action.

Bank accounts
The Bank may open correspondent accounts in central banks of countries with a country rating of not less than AA- (Standard&Poor's, Fitch) or Aa3 (Moody's), International Settlements Bank and commercial banks with rating of not less than AA- (Standard&Poor's, Fitch) or Aa3 (Moody's).

Depository services
Central banks with a country rating of not less than AA- (Standard&Poor's, Fitch) or Aa3 (Moody's), International Settlements Bank and commercial banks with a rating of not less than AA- (Standard&Poor's, Fitch) or Aa3 (Moody's) may act as foreign depository for securities of the Bank.

Financial market counterparties
Only financial institutions with credit rating of not less than A+ (Standard & Poor`s, Fitch) and A1 (Moody`s) may be financial market counterparties of the Bank.

Derivative financial instruments
Credit risk arising from derivative financial instruments is, at any time, limited to those with positive fair values, as recorded in the statement of financial position.

The Bank's maximum exposure to credit risk is reflected in the carrying amounts of financial assets in the statement of financial position. The impact of possible netting of assets and liabilities to reduce potential credit exposure is not significant. The credit risk is mitigated by collateral and other credit enhancements as disclosed in Notes 7, 8, 9, 10 and 11.

In order to monitor credit risk exposures, regular reports are produced by the officers of Market Operations Department based on a structured analysis focusing on the customer's business and financial performance. Any significant exposures against customers with deteriorating creditworthiness are reported to and reviewed by the Management Board.

The Bank's Market Operations Department reviews ageing analysis of outstanding loans and follows up on past due balances. Management therefore considers it appropriate to provide ageing and other information about credit risk as disclosed in Notes 7, 9, 10 and 11.

Loans to local banks portfolio is classified as follows:
- Refinancing loans
- Lender of last resort loans
- Loans under government guarantee

The Bank classifies its investment held to maturity portfolio as follows:

High grade - government securities having no changes in the terms and conditions, and no overdue in principal and interest.

Sub-standard grade – government securities having changes in the terms and conditions of loan agreements and no overdue in principal and interest.

It is the Bank's policy to maintain accurate and consistent risk ratings across the credit portfolio. The attributed risk ratings are assessed and updated regularly.

Market risk. The Bank takes on exposure to market risks. Market risks arise from open positions in (a) currency and (b) interest rate, all of which are exposed to general and specific market movements. Management sets limits on the value of risk that may be accepted, which is monitored on a daily basis. However, the use of this approach does not prevent losses outside of these limits in the event of more significant market movements.

Currency risk. Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. Subject to the currency structure of assets, the value of assets of the Bank is exposed to risk of changes in exchange rates of main foreign currencies.

The foreign currency assets of the Bank are primarily maintained in US Dollars, Euro and Pound Sterling. Currency composition of assets was defined by the "Main Directions for Management of Currency Assets of the Central Bank of the Republic of Azerbaijan" approved by the resolution of the Management Board dated 4 March 2009. This document is taken as a basis by the Market Operations department of the Bank, who is the major body responsible for management of the currency risk. Also the department acts in accordance with its own charter approved by the Management Board.

Currency risk is managed through diversification of foreign currency portfolio and determination of the following parameters:

- foreign currencies subject to management;
- maximum share of the managed currency in the total assets denominated in foreign currencies (minimum volume for the base currency).

The table below summarises the Bank's exposure to foreign currency exchange rate risk on its monetary assets and liabilities at 31 December 2011:

In thousands of Azerbaijani Manats	AZN	USD	EUR	GBP	SDR	Other	Total
Financial assets							
Cash and cash equivalents	269	4,380,872	1,858,281	442,981	-	101	6,682,504
SDR holdings with the IMF	-	-	-	-	185,029	-	185,029
Trading securities	-	1,176,207	230,746	99,386	-		1,506,339
Loans to local banks	2,080,159	-	-	-	-	-	2,080,159
Investment securities	163,962	197,521	-	-	-	-	361,483
Promissory note from the Government	221,095	-	-	-	-	-	221,095
Other financial assets	1,832	-	-	-	-	-	1,832
Total financial assets	**2,467,317**	**5,754,600**	**2,089,027**	**542,367**	**185,029**	**101**	**11,038,441**
Financial liabilities:							
Money issued in circulation	7,658,486	-	-	-	-	-	7,658,486
Amounts due to credit institutions	653,642	183,155	26,413	4,487	-	-	867,697
Amounts due to government organizations	2,389,071	109,034	347	4,671	-	101	2,503,224
Amounts due to other organisations	4,674	3	1	-	-	-	4,678
Debt securities issued	50,185	-	-	-	-	-	50,185
Amounts due to international financial institutions	153	3,616	-	-	-	-	3,769
Liabilities on transactions with the International Monetary Fund	659	-	-	-	207,514	-	208,173
Other financial liabilities	504	25	1,199	-	-	77	1,805
Total financial liabilities	**10,757,374**	**295,833**	**27,960**	**9,158**	**207,514**	**178**	**11,298,017**
Derivatives	**-**	**62,168**	**(45,470)**	**(7,019)**	**-**	**(7,891)**	**1,788**
Net balance sheet position	**(8,290,057)**	**5,520,935**	**2,015,597**	**526,190**	**(22,485)**	**(7,968)**	**(257,788)**

Derivatives presented above are monetary financial assets or monetary financial liabilities, but are presented separately in order to show the Bank's gross exposure.

The table below summarises the Bank's exposure to foreign currency exchange rate risk on its monetary assets and liabilities at 31 December 2010:

In thousands of Azerbaijani Manats	AZN	USD	EUR	GBP	SDR	Other	Total
Financial assets							
Cash and cash equivalents	101	2,567,416	1,146,646	49,184	-	108	3,763,455
SDR holdings with the IMF	-	-	-	-	189,638	-	189,638
Trading securities	-	501,539	179,234	69,083	-	4,851	754,707
Loans to local banks	1,912,718	-	-	-	-	-	1,912,718
Investment securities	193,162	397,468	217,215	238,261	-	-	1,046,106
Promissory note from the Government	216,472	-	-	-	-	-	216,472
Other financial assets	2,934	2,785	8	-	-	-	5,727
Total financial assets	**2,325,387**	**3,469,208**	**1,543,103**	**356,528**	**189,638**	**4,959**	**7,888,823**
Financial liabilities:							
Money issued in circulation	5,793,219	-	-	-	-	-	5,793,219
Amounts due to credit institutions	609,125	112,596	11,184	-	-	-	732,905
Amounts due to government organizations	932,147	313,407	7,400	1,149	-	109	1,254,212
Amounts due to other organisations	2,400	3	1	-	-	-	2,404
Debt securities issued	34,193	-	-	-	-	-	34,193
Amounts due to international financial institutions	73	4,044	-	-	-	-	4,117
Liabilities on transactions with the International Monetary Fund	656	-	-	-	225,792	-	226,448
Other financial liabilities	139	3,619	222	-	-	-	3,980
Total financial liabilities	**7,371,952**	**433,669**	**18,807**	**1,149**	**225,792**	**109**	**8,051,478**
Derivatives	**-**	**69,090**	**(55,540)**	**(10,515)**	**-**	**(4,355)**	**(1,320)**
Net balance sheet position	**(5,046,565)**	**3,104,629**	**1,468,756**	**344,864**	**(36,154)**	**495**	**(163,975)**

Amounts disclosed in respect of derivatives represent the fair value, at the end of the reporting period, of the respective currency that the Bank agreed to buy (positive amount) or sell (negative amount) before netting of positions and payments with the counterparty. The amounts by currency are presented gross as stated in Note 30. The net total represents the fair value of the currency derivatives. The above analysis includes only monetary assets and liabilities.

The following tables present sensitivities of profit or loss to reasonably possible changes in exchange rates applied at the end of the reporting period relative to the functional currency of the Bank, with all other variables held constant:

	2011				
In thousands of Azerbaijani Manats	USD	EUR	GBP	SDR	Other
Increase in currency rate of 1%	55,209	20,156	5,262	(225)	(80)
Increase in currency rate of 5%	276,047	100,780	26,310	(1,124)	(398)
Increase in currency rate of 10%	552,094	201,560	52,619	(2,249)	(797)
Decrease in currency rate of 1%	(55,209)	(20,156)	(5,262)	225	80
Decrease in currency rate of 5%	(276,047)	(100,780)	(26,310)	1,124	398
Decrease in currency rate of 10%	(552,094)	(201,560)	(52,619)	2,249	797

	2010				
In thousands of Azerbaijani Manats	USD	EUR	GBP	SDR	Other
Increase in currency rate of 1%	31,046	14,688	3,449	(362)	5
Increase in currency rate of 5%	155,231	73,438	17,243	(1,808)	25
Increase in currency rate of 10%	310,463	146,876	34,486	(3,615)	50
Decrease in currency rate of 1%	(31,046)	(14,688)	(3,449)	362	(5)
Decrease in currency rate of 5%	(155,231)	(73,438)	(17,243)	1,808	(25)
Decrease in currency rate of 10%	(310,463)	(146,876)	(34,486)	3,615	(50)

The exposure was calculated only for monetary balances denominated in currencies other than the functional currency of the Bank.

Interest rate risk. The Bank takes on exposure to the effects of fluctuations in the prevailing levels of market interest rates on its financial position and cash flows. Interest margins may increase as a result of such changes but may reduce or create losses in the event that unexpected movements arise. The main objective when managing the interest rate risk is to maintain stable return on investments while not exceeding the risk levels that can be undertaken per investment policies. Management monitors on a daily basis and sets limits on the level of mismatch of interest rate repricing that may be undertaken.

The table below summarises the Bank's exposure to interest rate risks. The table presents the aggregated amounts of the Bank's financial assets and liabilities at carrying amounts, categorised by the earlier of contractual interest repricing or maturity dates.

In thousands of Azerbaijani Manats	Demand and less than 1 month	From 1 to 6 months	From 6 to 12 months	More than 1 year	Non-interest bearing	Total
31 December 2011						
Total financial assets	5,931,133	2,331,662	283,819	2,389,567	104,393	11,040,574
Total financial liabilities	52,119	4,522	5,138	200,348	11,036,235	11,298,362
Net interest sensitivity gap at 31 December 2011	**5,879,014**	**2,327,140**	**278,681**	**2,189,219**	**(10,931,842)**	**(257,788)**
31 December 2010						
Total financial assets	3,463,846	2,023,053	215,651	2,076,410	109,980	7,888,940
Total financial liabilities	33,883	4,145	6,263	220,467	7,788,157	8,052,915
Net interest sensitivity gap at 31 December 2010	**3,429,963**	**2,018,908**	**209,388**	**1,855,943**	**(7,678,177)**	**(163,975)**

All of the Bank's debt instruments reprice within 5 years (2010: all reprice within 5 years).

The Bank monitors interest rates for its financial instruments. The table below summarises interest rates at the respective reporting date based on reports reviewed by key management personnel. For securities, the interest rates represent yields to maturity based on market quotations at the reporting date:

	31/12/2011					
In % p.a.	AZN	USD	EUR	GBP	SDR	Other
Assets						
Cash and cash equivalents	-	0.21	0.19	-	-	-
SDR holdings with the IMF	-	-	-	-	0.40	-
Trading securities	-	1.12	2.96	-	-	4.16
Loans to local banks	3.90	-	-	-	-	-
Investment securities	0.95	0.17	-	-	-	-
Promissory note from the Government	2.00	-	-	-	-	-
Other financial assets:						
- Loans to employees	11.00	-	-	-	-	-
Liabilities						
Debt securities issued	2.89	-	-	-	-	-
Amounts due to international financial institutions	-	1.00	-	-	-	-
Liabilities on transactions with the International Monetary Fund	-	-	-	-	0.50	-

The sign "-" in the table above means that the Bank does not have the respective assets or liabilities in the corresponding currency.

	31/12/2010					
In % p.a.	AZN	USD	EUR	GBP	SDR	Other
Assets						
Cash and cash equivalents	-	0.21	0.19	-	-	-
SDR holdings with the IMF	-	-	-	-	0.29	-
Trading securities	-	0.52	1.29	1.15	-	2.90
Loans to local banks	2.50	-	-	-	-	-
Investment securities	0.95	0.79	0.6	0.58	-	-
Promissory note from the Government	2.00	-	-	-	-	-
Other financial assets:						
- Loans to employees	11.00	-	-	-	-	-
Liabilities						
Debt securities issued	1.80	-	-	-	-	-
Amounts due to international financial institutions	-	1.00	-	-	-	-
Liabilities on transactions with the International Monetary Fund	-	-	-	-	0.50	-

Geographical risk concentrations. The geographical concentration of the Bank's financial assets and liabilities at 31 December 2011 is set out below:

In thousands of Azerbaijani Manats	Azerbaijan	OECD	Total
Financial assets			
Cash and cash equivalents	100,928	6,581,576	6,682,504
SDR holdings with the IMF	-	185,029	185,029
Trading securities	-	1,506,339	1,506,339
Loans to local banks	2,080,159	-	2,080,159
Investment securities	163,962	197,521	361,483
Promissory note from the Government	221,095	-	221,095
Other financial assets	1,921	2,044	3,965
Total financial assets	**2,568,065**	**8,472,509**	**11,040,574**
Financial liabilities			
Money issued in circulation	7,658,486	-	7,658,486
Amounts due to credit institutions	867,697	-	867,697
Amounts due to government organizations	2,503,224	-	2,503,224
Amounts due to other organisations	4,678	-	4,678
Debt securities issued	50,185	-	50,185
Amounts due to international financial institutions	-	3,769	3,769
Liabilities on transactions with the International Monetary Fund	-	208,173	208,173
Other financial liabilities	581	1,569	2,150
Total financial liabilities	**11,084,851**	**213,511**	**11,298,362**
Net position in on-balance sheet financial instruments	**(8,516,786)**	**8,258,998**	**(257,788)**

Assets and liabilities have been based on the country in which the counterparty is located.

The geographical concentration of the Bank's assets and liabilities at 31 December 2010 is set out below:

In thousands of Azerbaijani Manats	Azerbaijan	OECD	Total
Financial assets			
Cash and cash equivalents	105,849	3,657,606	3,763,455
SDR holdings with the IMF	-	189,638	189,638
Trading securities	-	754,707	754,707
Loans to local banks	1,912,718	-	1,912,718
Investment securities	193,162	852,944	1,046,106
Promissory note from the Government	216,472	-	216,472
Other financial assets	2,942	2,902	5,844
Total financial assets	**2,431,143**	**5,457,797**	**7,888,940**

In thousands of Azerbaijani Manats	Azerbaijan	OECD	Total
Financial liabilities			
Money issued in circulation	5,793,219	-	5,793,219
Amounts due to credit institutions	732,905	-	732,905
Amounts due to government organizations	1,254,212	-	1,254,212
Amounts due to other organisations	2,404	-	2,404
Debt securities issued	34,193	-	34,193
Amounts due to international financial institutions	-	4,117	4,117
Liabilities on transactions with the International Monetary Fund	-	226,448	226,448
Other financial liabilities	361	5,056	5,417
Total financial liabilities	**7,817,294**	**235,621**	**8,052,915**
Net position in on-balance sheet financial instruments	**(5,386,151)**	**5,222,176**	**(163,975)**

Liquidity risk. Liquidity risk is the risk that the Bank will be unable to meet its payment obligations when they fall due under normal and stress circumstances. Management of the liquidity risk by the Bank is based on keeping the liquidity at required level for meeting the requirements of the Bank in any condition.

In order to achieve the Bank's primary goals of maintaining currency stability and control over monetary policy, the Bank maintains operational foreign currency assets which are a group of liquid assets from its foreign currency assets to ensure timely intervention when deemed necessary. Such group of operational liquid foreign currency assets of the Bank is adequate for meeting the foreign currency demand for currency intervention, financing foreign trade equivalent of three-month import, and financing short-term foreign debt of the country. Liquidity risk management consists of identifying the liquid assets and determining the minimum liquidity limits of foreign currency assets over its investment period.

The table below shows liabilities at 31 December 2011 by their remaining contractual maturity. The amounts disclosed in the maturity table are the contractual undiscounted cash flows. Such undiscounted cash flows differ from the amount included in the statement of financial position because the amount in the statement of financial position is based on discounted cash flows. Financial derivatives are included at the contractual amounts to be paid or received, unless the Bank expects to close the derivative position before its maturity date in which case the derivatives are included based on the expected cash flows.

The table below shows maturity analysis of non-derivative financial assets at their carrying amounts and based on their contractual maturities except for assets that are readily saleable in case it would be necessary to meet cash outflows on financial liabilities. Such financial assets are included in the maturity analysis based on their expected date of disposal. Impaired loans are included at their carrying amounts net of impairment provisions and based on the expected timing of cash inflows. Derivatives are presented based on their contractual maturities.

When the amount payable is not fixed, the amount disclosed is determined by reference to the conditions existing at the end of the reporting period. Foreign currency payments are translated using the spot exchange rate at the end of the reporting period.

The maturity analysis of financial instruments at 31 December 2011 is as follows:

In thousands of Azerbaijani Manats	Demand and less than 1 month	From 1 to 6 months	From 6 to 12 months	From 12 months to 5 years	Over 5 years	Total
Assets						
Cash and cash equivalents	4,390,908	2,291,596	-	-	-	6,682,504
SDR holdings with the IMF	-	57	-	-	184,972	185,029
Trading securities	1,506,339	-	-	-	-	1,506,339
Loans to local banks	133,231	41,006	86,384	900,929	918,609	2,080,159
Investment securities	-	-	197,521	40,004	123,958	361,483
Promissory note from the Government	-	-	-	-	221,095	221,095
Gross settled forwards:						
- inflows	79,767	-	-	-	-	79,767
- outflows	(77,634)	-	-	-	-	(77,634)
Other financial assets	1,832	-	-	-	-	1,832
Total	**6,034,443**	**2,332,659**	**283,905**	**940,933**	**1,448,634**	**11,040,574**
Liabilities						
Money in circulation	7,658,486	-	-	-	-	7,658,486
Amounts due to credit institutions	867,697	-	-	-	-	867,697
Amounts due to government organizations	2,503,224	-	-	-	-	2,503,224
Amounts due to other organisations	4,678	-	-	-	-	4,678
Debt securities in issue	50,335	-	-	-	-	50,335
Amounts due to international financial institutions	283	196	196	2,023	1,286	3,984
Liabilities on transactions with the International Monetary Fund	1,651	4,338	4,954	11,713	185,924	208,580
Gross settled forwards:						
- inflows	(8,786)	(17,123)	-	-	-	(25,909)
- outflows	8,987	17,268	-	-	-	26,255
Other financial liabilities	788	145	872	-	-	1,805
Total potential future payments for financial obligations	**11,087,343**	**4,824**	**6,022**	**13,736**	**187,210**	**11,299,135**
Liquidity gap arising from financial instruments	**(5,052,900)**	**2,327,835**	**277,883**	**927,197**	**1,261,424**	**(258,561)**

The maturity analysis of financial instruments at 31 December 2010 is as follows:

In thousands of Azerbaijani Manats	Demand and less than 1 month	From 1 to 6 months	From 6 to 12 months	From 12 months to 5 years	Over 5 years	Total
Assets						
Cash and cash equivalents	2,572,949	1,190,506	-	-	-	3,763,455
SDR holdings with the IMF	189,638	-	-	-	-	189,638
Trading securities	754,707	-	-	-	-	754,707
Loans to local banks	17,947	178,474	23,532	282,250	1,410,515	1,912,718
Investment securities	34,448	654,062	192,047	40,004	125,545	1,046,106
Promissory note from the Government	-	-	-	-	216,472	216,472
Gross settled forwards:						
- inflows	22,996	-	-	-	-	22,996
- outflows	(22,879)	-	-	-	-	(22,879)
Other financial assets	4,020	11	72	281	1,343	5,727
Total	**3,573,826**	**2,023,053**	**215,651**	**322,535**	**1,753,875**	**7,888,940**
Liabilities						
Money in circulation	5,793,219	-	-	-	-	5,793,219
Amounts due to credit institutions	731,316	-	1,589	-	-	732,905
Amounts due to government organizations	1,254,212	-	-	-	-	1,254,212
Amounts due to other organisations	2,404	-	-	-	-	2,404
Debt securities in issue	34,218	-	-	-	-	34,218
Amounts due to international financial institutions	309	-	207	1,542	2,204	4,262
Liabilities on transactions with the International Monetary Fund	226,542	470	564	4,511	-	232,087
Gross settled forwards:						
- inflows	(71,010)	(20,491)	-	-	-	(91,501)
- outflows	72,344	20,594	-	-	-	92,938
Other financial liabilities	3,980	-	-	-	-	3,980
Total potential future payments for financial obligations	**8,047,534**	**573**	**2,360**	**6,053**	**2,204**	**8,058,724**
Liquidity gap arising from financial instruments	**(4,473,708)**	**2,022,480**	**213,291**	**316,482**	**1,751,671**	**(169,784)**

The Bank does not use the above maturity analysis based on undiscounted contractual maturities of liabilities to manage liquidity. Instead, the Bank monitors expected maturities and the resulting expected liquidity gap as follows:

The maturity analysis of financial instruments at 31 December 2011 is as follows:

In thousands of Azerbaijani Manats	Demand and less than 1 month	From 1 to 6 months	From 6 to 12 months	From 12 months to 5 years	Over 5 years	Total
Assets						
Cash and cash equivalents	4,390,908	2,291,596	-	-	-	6,682,504
SDR holdings with the IMF	-	57	-	-	184,972	185,029
Trading securities	1,506,339	-	-	-	-	1,506,339
Loans to local banks	133,231	41,006	86,384	900,929	918,609	2,080,159
Investment securities	-	-	197,521	40,004	123,958	361,483
Promissory note from the Government	-	-	-	-	221,095	221,095
Gross settled forwards:						
- inflows	79,767	-	-	-	-	79,767
- outflows	(77,634)	-	-	-	-	(77,634)
Other financial assets	1,832	-	-	-	-	1,832
Total	**6,034,443**	**2,332,659**	**283,905**	**940,933**	**1,448,634**	**11,040,574**
Liabilities						
Money in circulation	7,658,486	-	-	-	-	7,658,486
Amounts due to credit institutions	867,697	-	-	-	-	867,697
Amounts due to government organizations	2,503,224	-	-	-	-	2,503,224
Amounts due to other organisations	4,678	-	-	-	-	4,678
Debt securities in issue	50,185	-	-	-	-	50,185
Amounts due to international financial institutions	283	184	184	1,843	1,275	3,769
Liabilities on transactions with the International Monetary Fund	1,651	4,338	4,954	11,713	185,517	208,173
Gross settled forwards:						
- inflows	(8,786)	(17,123)	-	-	-	(25,909)
- outflows	8,987	17,267	-	-	-	26,254
Other financial liabilities	788	145	872	-	-	1,805
Total potential future payments for financial obligations	**11,087,193**	**4,811**	**6,010**	**13,556**	**186,792**	**11,298,362**
Liquidity gap arising from financial instruments	**(5,052,750)**	**2,327,848**	**277,895**	**927,377**	**1,261,842**	**(257,788)**

The entire portfolio of trading securities is classified within demand and less than one month based on management's assessment of the portfolio's realisability.

Management believes that in spite of the fact that the Bank's liabilities for money in circulation as well as for amounts due to credit institutions and government organisations are classified as being on demand, the nature of the liabilities and past experience of the Bank would indicate that their full settlement will not be claimed in the short-term and therefore provide a long-term and stable source of funding for the Bank.

The maturity analysis of financial instruments at 31 December 2010 is as follows:

In thousands of Azerbaijani Manats	Demand and less than 1 month	From 1 to 6 months	From 6 to 12 months	From 12 months to 5 years	Over 5 years	Total
Assets						
Cash and cash equivalents	2,572,949	1,190,506	-	-	-	3,763,455
SDR holdings with the IMF	189,638	-	-	-	-	189,638
Trading securities	754,707	-	-	-	-	754,707
Loans to local banks	17,947	178,474	23,532	282,250	1,410,515	1,912,718
Investment securities	34,448	654,062	192,047	40,004	125,545	1,046,106
Promissory note from the Government	-	-	-	-	216,472	216,472
Gross settled forwards:						
- inflows	22,996	-	-	-	-	22,996
- outflows	(22,879)	-	-	-	-	(22,879)
Other financial assets	4,020	11	72	281	1,343	5,727
Total	**3,573,826**	**2,023,053**	**215,651**	**322,535**	**1,753,875**	**7,888,940**
Liabilities						
Money in circulation	5,793,219	-	-	-	-	5,793,219
Amounts due to credit institutions	731,316	-	1,589	-	-	732,905
Amounts due to government organizations	1,254,212	-	-	-	-	1,254,212
Amounts due to other organisations	2,404	-	-	-	-	2,404
Debt securities in issue	34,193	-	-	-	-	34,193
Amounts due to international financial institutions	305	-	188	1,506	2,118	4,117
Liabilities on transactions with the International Monetary Fund	974	4,145	4,486	27,976	188,867	226,448
Gross settled forwards:						
- inflows	(71,010)	(20,491)	-	-	-	(91,501)
- outflows	72,344	20,594	-	-	-	92,938
Other financial liabilities	3,980	-	-	-	-	3,980
Total potential future payments for financial obligations	**7,821,937**	**4,248**	**6,263**	**29,482**	**190,985**	**8,052,915**
Liquidity gap arising from financial instruments	**(4,248,111)**	**2,018,805**	**209,388**	**293,053**	**1,562,890**	**(163,975)**

28. Management of Capital

The capital of the Bank comprises the residual value of the Bank’s assets after deduction of all its liabilities.

The Bank’s objectives when managing capital are to maintain an appropriate level of capital to ensure economic independence of the Bank and ability to perform its functions. The Bank considers total capital under management to be equity shown in the statement of financial position as disclosed in these financial statements.

No external capital requirements exist for the Bank as the central bank, except for the size of the statutory capital and minimum amount capital reserves stipulated by the Law of the Republic of Azerbaijan “On the Central Bank of the Republic of Azerbaijan” (the “Law”).

As disclosed in Note 22, at 31 December 2011 the authorized and fully paid capital of the Bank was AZN 10,000 thousand (31 December 2010: AZN 10,000 thousand).

According to Article 10.3 of the Law, capital reserves should make up 15% of the national currency in cash put into circulation by the Bank and are established by allocations from the profit for the year. The difference resulting from the revaluation of assets and liabilities that are held in gold and foreign currency because of changes in the rate of Azerbaijani Manat is accounted for in the statement of comprehensive income of the Bank, but shall not be taken into consideration in the calculation of the capital reserves. Upon establishment of capital reserves, the residual balance of realized profit of the Bank shall be transferred to the State Budget.

Due to the fact that the capital reserves of the Bank at 31 December 2010 were not at the level required by the Law, there were no transfers made to the State Budget during the year 2011. At 31 December 2011, the Bank did not have the capital reserves required by the Law and therefore, no liability was recognised for the transfers to the State Budget.

29. Contingencies and Commitments

Legal proceedings. From time to time and in the normal course of operations, claims against the Bank may be received. On the basis of its own estimates and both internal professional advice management is of the opinion that no material losses will be incurred in respect of claims and accordingly no provision has been made in these financial statements.

Operating lease commitments. As at 31 December 2011 and 2010, the Bank did not have material commitments under non-cancellable operating leases.

30. Derivative Financial Instruments

		31/12/2011		31/12/2010	
In thousands of Azerbaijani Manats	Note	Contracts with positive fair value	Contracts with negative fair value	Contracts with positive fair value	Contracts with negative fair value
Foreign exchange forwards: fair values, at the end of the reporting period, of	31				
- USD receivable on settlement (+)		62,390	21,545	503	91,234
- USD payable on settlement (-)		(17,233)	(4,534)	(22,379)	(268)
- Euros receivable on settlement (+)		11,032	4,364	17,135	-
- Euros payable on settlement (-)		(49,796)	(11,070)	-	(72,675)
- Pound Sterling receivable on settlement (+)		3,552	-	2,778	267
- Pound Sterling payable on settlement (-)		(7,163)	(3,408)	(500)	(13,060)
- Other currencies receivable on settlement (+)		2,793	-	2,580	-
- Other currencies payable on settlement (-)		(3,442)	(7,242)	-	(6,935)
Net fair value of foreign exchange forwards	13, 21	**2,133**	**(345)**	**117**	**(1,437)**

Foreign exchange derivative financial instruments entered into by the Bank are generally traded in an over-the-counter market with professional market counterparties on standardised contractual terms and conditions. Derivatives have potentially favourable (assets) or unfavourable (liabilities) conditions as a result of fluctuations in market interest rates, foreign exchange rates or other variables relative to their terms. The aggregate fair values of derivative financial assets and liabilities can fluctuate significantly from time to time.

31. Fair Value of Financial Instruments

(a) Fair values of financial instruments carried at amortised cost.

Fair values of financial instruments carried at amortised cost are as follows:

In thousands of Azerbaijani Manats	31/12/2011 Carrying amount	31/12/2011 Fair value	31/12/2010 Carrying amount	31/12/2010 Fair value
FINANCIAL ASSETS				
Cash and cash equivalents				
- Cash on hand	100,928	100,928	105,849	105,849
- Placements with non-resident credit institutions	6,581,576	6,581,576	3,657,606	3,657,606
SDR holdings with the IMF	185,029	185,029	189,638	189,638
Loans to local banks				
- Loans under government guarantee	1,530,817	1,530,817	1,362,003	1,362,003
- Refinancing loans	549,342	549,342	531,905	531,905
- Lender of last resort loans	-	-	18,810	18,810
Investment securities				
- Bonds issued by the Ministry of Finance of the Republic of Azerbaijan	123,958	108,987	129,998	113,811
- US Treasury bills	197,521	197,521	119,699	119,699
- UK Treasury bills	-	-	238,260	238,260
- France government Treasury bills	-	-	137,077	137,077
- International Bank for Reconstruction and Development	-	-	119,778	119,778
- Italy government Treasury bills	-	-	61,569	61,569
- Germany government Treasury bills	-	-	52,727	52,727
- BMT Nordic Investment Bank	-	-	41,041	41,041
- Germany State Agency KWF	-	-	27,412	27,412
- France State Agency SFE	-	-	24,153	24,153
- Spain government Treasury bills	-	-	20,488	20,488
- German Regional State	-	-	10,740	10,740
Promissory note from the Government	221,095	221,095	216,472	216,472
Other financial assets				
- Receivables for investments disposed	-	-	2,785	2,785
- Loans to employees	1,601	1,601	1,713	1,713
- Advances received for foreign currency dealing operations	154	154	228	228
- Other debtors	77	77	1,001	1,001
TOTAL FINANCIAL ASSETS CARRIED AT AMORTISED COST	**9,492,098**	**9,477,127**	**7,070,952**	**7,054,765**

In thousands of Azerbaijani Manats	31/12/2011 Carrying amount	31/12/2011 Fair value	31/12/2010 Carrying amount	31/12/2010 Fair value
FINANCIAL LIABILITIES				
Money issued in circulation	7,658,486	7,658,486	5,793,219	5,793,219
Amounts due to credit institutions				
- Current accounts	725,701	725,701	704,681	704,681
- Obligatory reserves	100,726	100,726	20,860	20,860
- Repurchase transactions	40,934	40,934	5,775	5,775
- Blocked accounts	336	336	1,589	1,589
Amounts due to government organizations				
- Amounts due to the Central Treasury of the Republic of Azerbaijan	2,360,519	2,360,519	1,140,700	1,140,700
- Amounts due to the State Oil Fund of the Republic of Azerbaijan	133,919	133,919	71,056	71,056
- Other demand deposits	8,786	8,786	42,456	42,456
Amounts due to other organisations				
- Public organisations	4,473	4,473	1,347	1,347
- Other financial institutions	186	186	250	250
- Other	19	19	807	807
Debt securities issued				
- Short-term notes	50,185	50,185	34,193	34,193
Amounts due to international financial institutions				
- Borrowings from International Development Association (IDA)	3,591	3,591	4,019	4,019
- Amounts due to other international financial institutions	178	178	98	98
Liabilities on transactions with the International Monetary Fund				
- IMF current accounts	659	659	656	656
- Borrowings from the IMF	22,598	22,598	37,792	37,792
- SDR allocation	184,916	184,916	188,000	188,000
Other financial liabilities				
- Advances received for the purchase of foreign currency	636	636	222	222
- Amounts payable for investments securities purchased	588	588	3,619	3,619
- Amounts in the course of settlement	581	581	139	139
TOTAL FINANCIAL LIABILITIES CARRIED AT AMORTISED COST	**11,298,017**	**11,298,017**	**8,051,478**	**8,051,478**

(b) Analysis by fair value hierarchy of financial instruments carried at fair value.

For financial instruments carried at fair value, the levels in the fair value hierarchy into which the fair values are categorised are as follows:

	31/12/2011		31/12/2010	
In thousands of Azerbaijani Manats	**Quoted price in an active market (Level 1)**	**Valuation technique with inputs observable in markets (Level 2)**	**Quoted price in an active market (Level 1)**	**Valuation technique with inputs observable in markets (Level 2)**
FINANCIAL ASSETS				
Trading securities	1,506,339	-	754,707	-
Investment securities available for sale	40,004	-	63,164	-
Foreign exchange forward contracts	-	2,133	-	117
TOTAL FINANCIAL ASSETS CARRIED AT FAIR VALUE	**1,546,343**	**2,133**	**817,871**	**117**

Management applies judgement in categorising financial instruments using the fair value hierarchy. If a fair value measurement uses observable inputs that require significant adjustment, that measurement is a Level 3 measurement. Significance of a valuation input is assessed against the fair value measurement in its entirety.

In thousands of Azerbaijani Manats	**31/12/2011 Valuation technique with inputs observable in markets (Level 2)**	**31/12/2010 Valuation technique with inputs observable in markets (Level 2)**
FINANCIAL LIABILITIES		
- Foreign exchange forward contracts	345	1,437
TOTAL FINANCIAL LIABILITIES CARRIED AT FAIR VALUE	**345**	**1,437**

(c) The methods and assumptions applied in determining fair values.

Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation, and is best evidenced by an active quoted market price. Where quoted market prices are not available, the Bank used valuation techniques. The fair value of floating rate instruments that are not quoted in an active market was estimated to be equal to their carrying amount. The fair value of unquoted fixed interest rate instruments was estimated based on estimated future cash flows expected to be received discounted at current interest rates for new instruments with similar credit risk and remaining maturity. When determining fair values of foreign exchange forward contracts using a valuation technique, the management assumed that foreign exchange rate patterns would change as expected and at the dates of settlement of the contracts they would not be significantly different from rates used as input to valuation technique.

Discount rates used depend on currency, maturity of the instrument and credit risk of the counterparty and were as follows:

	31/12/2011	31/12/2010
Cash and cash equivalents		
- Placements with non-resident credit institutions	0.09% - 0.24% p.a.	0.11% - 0.35% p.a.
Trading securities		
- Agency notes	0% - 5.25% p.a.	0.49% - 5.35% p.a.
- US Treasury notes	0.13% - 3.5% p.a.	0.38% - 4.88% p.a.
- Government bonds	0.5% - 6.75% p.a.	3 month – LIBOR – 0.05%, 0.73% - 6.50% p.a.
- Notes issued by international financial institutions	0.51% - 4.50% p.a.	3 month LIBOR, 2.00% - 5.00% p.a.
- Regional authority notes	0% - 0.94% p.a.	0.73% p.a.
- UK Treasury notes	0% - 6.59% p.a.	2.25% - 9.00% p.a.
- Corporate bonds	0.78% - 4.10% p.a.	0.36% - 5.25% p.a.
- Mortgage-backed securities	-	5.50% - 6.50% p.a.
Loans to local banks		
- Loans under government guarantee	3.00% - 5.50% p.a.	3.00% - 4.00% p.a.
- Refinancing loans	2.00% - 5.69% p.a.	2.00% - 4.00% p.a.
- Lender of last resort loans	2.00% p.a.	2.00% p.a.
Special Drawing Rights holdings with the IMF	0.40% p.a.	0.22% - 0.40%p.a.
Investment securities		
- Bonds issued by the Ministry of Finance of the Republic of Azerbaijan	0.15% - 2.00% p.a.	0.15% - 2.00% p.a.
- US Treasury bills	0.38% - 1.38% p.a.	0% - 0.88% p.a.
- UK Treasury bills	-	0% - 5.13% p.a.
- France government Treasury bills	-	0.56% - 0.63% p.a.
- International Bank for Reconstruction and Development	-	0.85% p.a.
- Italy government Treasury bills	-	6.00% p.a.
- Germany government Treasury bills	-	0.56% p.a.
- BMT Nordic Investment Bank	-	3.88% p.a.
- Germany State Agency KWF	-	4.00% p.a.
- France State Agency SFE	-	2.00% p.a.
- Spain government Treasury bills	-	3.38% p.a.
- German Regional State	-	4.13% p.a.
- Azerbaijan Mortgage Fund	-	3.00% - 3.25% p.a.
Promissory note from the Government	***2.00% p.a.***	***2.00% p.a.***
Other financial assets		
- Loans to employees	11.00% p.a.	11.00% p.a.
Debt securities in issue	***2.79% - 2.99% p.a.***	***1.42% - 2.16% p.a.***
Amounts due to International financial institutions		
- Borrowings from International Development Association (IDA)	1.00% p.a.	1.00% p.a.
- Amounts due to other international financial institutions	1.00% p.a.	1.00% p.a.
Liabilities on transactions with the International Monetary Fund	***0.50% p.a.***	***0.50% p.a.***

32. Presentation of Financial Instruments by Measurement Category

For the purposes of measurement, IAS 39, Financial Instruments: Recognition and Measurement, classifies financial assets into the following categories: (a) loans and receivables; (b) available-for-sale financial assets; (c) financial assets held to maturity and (d) financial assets at fair value through profit or loss ("FVTPL"). Financial assets at fair value through profit or loss have two subcategories: (i) assets designated as such upon initial recognition, and (ii) those classified as held for trading. The following table provides a reconciliation of financial assets with these measurement categories as of 31 December 2011:

In thousands of Azerbaijani Manats	Loans and receivables	Trading assets	Held to maturity	Total
ASSETS				
Cash and cash equivalents	6,682,504	-	-	6,682,504
Special Drawing Rights with the IMF	185,029	-	-	185,029
Trading securities	-	1,506,339	-	1,506,339
Loans to local banks	2,080,159	-	-	2,080,159
Investment securities	163,962	-	197,521	361,483
Promissory note from the Government	221,095	-	-	221,095
Other financial assets	1,832	2,133	-	3,965
TOTAL FINANCIAL ASSETS	**9,334,581**	**1,508,472**	**197,521**	**11,040,574**

The following table provides a reconciliation of financial assets with the measurement categories at 31 December 2010:

In thousands of Azerbaijani Manats	Loans and receivables	Available-for-sale assets	Trading assets	Held to maturity	Total
ASSETS					
Cash and cash equivalents	3,763,455	-	-	-	3,763,455
Special Drawing Rights with the IMF	189,638	-	-	-	189,638
Trading securities	-	-	754,707	-	754,707
Loans to local banks	1,912,718	-	-	-	1,912,718
Investment securities	170,002	23,160	-	852,944	1,046,106
Promissory note from the Government	216,472	-	-	-	216,472
Other financial assets	5,727	-	117	-	5,844
TOTAL FINANCIAL ASSETS	**6,258,012**	**23,160**	**754,824**	**852,944**	**7,888,940**

As of 31 December 2011 and 31 December 2010 all of the Bank's financial liabilities except for derivatives were carried at amortised cost. Derivatives belong to the fair value through profit or loss measurement category

33. Related Party Transactions

Parties are generally considered to be related if the parties are directly or indirectly under common control or one party has the ability to control the other party or can exercise significant influence over the other party in making financial or operational decisions. In considering each possible related party relationship, attention is directed to the substance of the relationship, not merely the legal form.

Related parties may enter into transactions which unrelated parties might not, and transactions between related parties may not be effected on the same terms, conditions and amounts as transactions between unrelated parties.

As disclosed in the Note 5, the Bank early adopted amendment to IAS 24, Related Party Disclosures and used exemption for disclosure of immaterial balances and transactions with government-related entities.

"Other related parties" represent the Azerbaijan Mortgage Fund ("AMF") and the Financial Monitoring Service ("FMS"). The Bank acts as supervisor of these entities as mandated by law, but it has no title over their assets and liabilities, has no share ownership and rights over their economic benefits arising from their activities. Refer to Note 4.

At 31 December 2011 and 31 December 2010, the outstanding balances with related parties were as follows:

	31/12/2011			31/12/2010		
In thousands of Azerbaijani Manats	Government of Azerbaijan and Government controlled entities	Key manage-ment personnel	Other related parties	Government of Azerbaijan and Government controlled entities	Key manage-ment personnel	Other related parties
Loans and advances (contractual interest rate: 3 - 11% p.a.)	964,387	41	-	1,045,371	51	-
Impairment provisions for loans and advances	(1,619)	-	-	(1,619)	-	-
Investment securities (contractual interest rate: 0.15 – 2.00% p.a.)	168,257	-	-	174,297	-	23,160
Impairment provisions for investment securities	(4,295)	-	-	(4,295)	-	-
Promissory note from the Government	221,095	-	-	216,472	-	-
Other assets	-	-	827	-	-	892
Amounts due to credit institutions (non-interest bearing)	120,850	-	-	103,887	-	-
Amounts due to government organisations (non-interest bearing)	2,500,166	-	3,058	1,252,325	-	1,887
Liabilities on transactions with the International Monetary Fund (contractual interest rate: 0. 5% p.a.)	207,514	-	-	225,792	-	-
Amounts due to international financial institutions (contractual interest rate: 1.0% p.a.)	3,591	-	-	4,019	-	-

The income and expense items with related parties for 2011 and 2010 were as follows:

In thousands of Azerbaijani Manats	2011 Government of Azerbaijan and Government controlled entities	2011 Key management personnel	2011 Other related parties	2010 Government of Azerbaijan and Government controlled entities	2010 Key management personnel	2010 Other related parties
Interest income on loans and advances	32,533	2	-	31,472	3	-
Interest income on investment securities	1,117	-	431	864	-	331
Interest income on promissory note from the Government	4,624	-	-	4,635	-	-
Provision for loan impairment	1,619	-	-	1,619	-	-
Administrative and other operating expenses	-	-	3,350	-	-	1,658

Key management compensation is presented below:

In thousands of Azerbaijani Manats	2011 Expense	2011 Accrued liability	2010 Expense	2010 Accrued liability
Short-term benefits:				
- Salaries	801	-	627	-
Total	**801**	**-**	**627**	**-**

During the year ended 31 December 2011, AZN 15,153 thousand of the liabilities of the Government of Azerbaijan Republic on the transactions with the International Monetary Fund was settled (2010: AZN 10,144 thousand).

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