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REPUBLIC OF AZERBAIJAN

FINANCIAL SECTOR ASSESSMENT PROGRAM

April 2025

FINANCIAL SYSTEM STABILITY ASSESSMENT

This paper on the Republic of Azerbaijan was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on March 4, 2025.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF AZERBAIJAN

FINANCIAL SYSTEM STABILITY ASSESSMENT

March 4, 2025

KEY ISSUES

Context: Azerbaijan's economy has recovered from two downturns prompted by the collapse of global oil prices in 2015 and COVID-19 pandemic in 2020. Since the previous FSAP in 2015, the financial soundness of its bank-dominated financial sector has improved significantly, enhancing its resilience amid recent global uncertainties. Indeed, the transfer of financial sector regulation back to the Central Bank of Azerbaijan (CBA) in 2019 has revitalized the regulatory reform agenda. Nonperforming loans have declined, and banks' profitability has surpassed pre-pandemic levels. With government support, the largest state-owned bank—International Bank of Azerbaijan—has recovered from its 2015 distress. Nonbank financial intermediation (⅓ of financial system assets) is largely dominated by state-owned specialized institutions.

Findings: An intensification of regional conflicts poses risks to the economy. Similarly, the high reliance on oil and gas revenues renders Azerbaijan vulnerable to oil and gas price declines. This in turn would impact banks' asset quality and liquidity. Key structural risks to banks stem from substantial reliance on volatile wholesale corporate deposits; continued high financial dollarization, particularly in business loans and deposits; and high credit concentration. While the authorities have taken measures to moderate the recent rapid growth in unsecured consumer credit, it remains a cyclical risk.

Policy advice: Further measures to strengthen regulation and supervision would reinforce financial sector resilience. As noted in previous FSAPs, addressing long-standing issues would entail fully implementing a consolidated supervision framework; safeguarding the CBA's independence; establishing an interagency body for crisis preparedness and management; and giving the CBA full powers for bank resolution. Furthermore, the FSAP recommends bolstering supervisory oversight and safety nets by establishing a comprehensive supervision cycle for banks; developing early warning indicators and triggers for supervisory actions; expanding the macroprudential policy toolkit; strengthening the emergency liquidity assistance framework as well as minimizing the risk of moral hazard with adequate safeguards against temporary public ownership.

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This report is based on the assessment work under the Financial Sector Assessment Program (FSAP) conducted during May and September-October 2024. The findings were discussed with the authorities in October 2024 (the close of the FSAP) and in January 2025 (the Article IV Consultation).

- The FSAP team was led by Julian T.S. Chow (Mission Chief) and included: Carlos de Barros (Deputy Mission Chief), Yesim Aydin, Ozge Emeksiz, Heena Gupta, Nik Ahmad Hafizi, Jiri Jonas, Bella Yao, and Solo Zerbo (all IMF), as well as Luis Martin Auqui (external expert). Zoltan Jakab contributed to the modeling of the adverse scenario. Ramanjeet Singh and Nchimunya Kabunda provided administrative assistance. The FSAP team also collaborated closely with the MCD Article IV Consultation team.

- The team met with the Central Bank of Azerbaijan Governor Taleh Kazimov, senior officials from the Ministry of Finance, Azerbaijan Deposit Insurance Fund, Aqrarkredit, Mortgage and Credit Guarantee Fund, as well as senior representatives of Azerbaijan Bankers' Association, banks, nonbank credit institutions, insurance companies, Center for Economic and Social Development, private law and audit firms, and international credit rating agencies.

- FSAPs assess the stability of the financial system as a whole and not that of individual institutions. They are intended to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance its resilience to shocks and contagion. Certain categories of risk affecting financial institutions, such as operational or legal risk, or risk related to fraud, are not covered in FSAPs.

- This report was prepared by Julian T.S. Chow, Carlos de Barros, and the Azerbaijan FSAP team.

CONTENTS

Glossary 5

EXECUTIVE SUMMARY 7

BACKGROUND 11

A. Context and Macrofinancial Developments 11

B. Financial Sector Landscape 17

SYSTEMIC RISK ASSESSMENT 23

A. Financial Sector Vulnerabilities and Risks 23

B. Risk Analysis Framework and Macrofinancial Scenarios 24

C. Contagion Analysis 33

D. Corporate Vulnerability Analysis 34

FINANCIAL SECTOR OVERSIGHT 36

A. Systemic Risk Oversight and Macroprudential Framework 36

B. Banking Supervision and Regulation 38

C. Financial Integrity 40

SYSTEMIC LIQUIDITY, FINANCIAL CRISIS MANAGEMENT AND RESOLUTION 41

A. Systemic Liquidity Management 41

B. Financial Safety Net and Crisis Management 42

AUTHORITIES' VIEWS 44

BOX

1. Rehabilitation of International Bank of Azerbaijan (IBA) 19

FIGURES

1. Recent Economic Development 13
2. Domestic Credit, Debt, and Real Estate Developments 14
3. Cross-Country Comparison of Banking Sector Financial Soundness Indicators, Q1 20241,2 15
4. Recent Developments in the Banking Sector 16
5. Structure of the Banking Sector 20
6. Financial Soundness Indicators of International Bank of Azerbaijan 21
7. Cross-Sectoral Exposures Map 22
8. Projections of Key Macrofinancial Variables under Baseline and Adverse Scenarios 26
9. Bank Solvency Stress Test 28

10. Manat Cash Flow-Based Analysis 31
11. Foreign Currency Cash Flow-Based Analysis 32
12. Interconnectedness and Contagion Analysis 33
13. Nonfinancial Corporate Balance Sheet Analysis 35

TABLES

1. Main FSAP Recommendations 9
2. Selected Economic Indicators, 2022-30 45
3. Financial Soundness Indicators, 2015-July 2024 46
4. Structure of the Financial System 47
5. COVID-19 Measures to Support the Financial Sector 48
6. Preliminary Risk Assessment Matrix 49
7. Progress on Implementing the 2015 FSAP Main Recommendations 51
8. Progress on Implementing the 2022 Development Module FSAP Main Recommendations on Financial Sector Stability 60

APPENDICES

I. Stress Testing Matrix 63
II. Banking Regulation and Supervision: Governance, Independence, 69
III. Financial Safety Net, Bank Resolution, and Crisis Management 71

Glossary

ADIF	Azerbaijan Deposit Insurance Fund
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
AZN	Azerbaijani Manat (national currency)
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
BIS	Bank for International Settlements
BO	Beneficial Owner
CAMELS	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
CAR	Capital Adequacy Ratio
CBA	Central Bank of the Republic of Azerbaijan
CPs	Core Principles for Effective Deposit Insurance Systems
CCoB	Capital Conservation Buffer
CCyB	Countercyclical Capital Buffer
D-SIBs	Domestic Systemically Important Banks
DSTI	Debt Service to Income
ELA	Emergency Liquidity Assistance
FIMSA	Financial Market Supervision Authority
FSDS	Financial Sector Development Strategy (2024-2026)
FSAP	Financial Sector Assessment Program
FSI	Financial Soundness Indicator
FSMA	Financial Sector Markets Authority
FSR	Financial Stability Report
FX	Foreign Exchange
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GFSR	Global Financial Stability Report
GMM	Global Macrofinancial Model
GRAM	Global Risk Assessment Matrix
HLA	Higher Loss Absorption
HTM	Held-to-Maturity
HQLA	High Quality Liquid Assets
IBA	International Bank of Azerbaijan
IFRS	International Financial Reporting Standards
IT	Information Technology
IMF	International Monetary Fund
LCBA	Law of the Republic of Azerbaijan on the Central Bank of the Republic of Azerbaijan
KA	Key Attributes
LGD	Loss Given Default
LCR	Liquidity Coverage Ratio

LB	Law of the Republic of Azerbaijan on Banks
LoLR	Lender of Last Resort
LTV	Loan to Value
MCGF	Mortgage and Credit Guarantee Fund
MOF	Ministry of Finance
MOU	Memorandum of Understanding
NBCI	Nonbank Credit Institutions
NBFI	Nonbank Financial Intermediation
NCWO	No Creditor Worse Off
NPL	Nonperforming Loan
NSFR	Net Stability Funding Ratio
PD	Probability of Default
RAM	Risk Assessment Matrix
RBS	Risk-based Supervision
RR	Reserve Requirements
RWA	Risk Weighted Asset
SME	Small and Medium Size Enterprise
SOE	State Owned Enterprise
SOFAZ	The State Oil Fund of Azerbaijan
SRA	Systemic Risk Assessment
ST	Stress Test
STeM	Stress Testing Matrix
SWF	Sovereign Wealth Fund
TA	Technical Assistance
TD	Top-Down
TLAC	Total Loss Absorbing Capacity
WB	World Bank
WEO	World Economic Outlook

EXECUTIVE SUMMARY

The Financial Sector Assessment Program (FSAP) took place against the backdrop of a stronger domestic macro-financial environment compared to the 2015 FSAP. Azerbaijan's economy has recovered from two downturns driven by a global oil price collapse in 2015 and COVID-19 in 2020. Over the last decade, foreign exchange reserves have doubled, and significant reforms have been carried out to reinvigorate the bank-dominated financial sector. The transfer of financial sector regulation back to the central bank in 2019 reinforced the regulatory reform agenda. New financial sector regulations and macroprudential policies were introduced to enhance prudential requirements, corporate governance, and risk management standards. Banks have incorporated lessons from the 2015-16 economic crisis, resulting in increased capital adequacy and a significant decline in net open position in foreign exchange.

While the financial sector emerged resilient from the downturns, some pockets of vulnerabilities remain. The main structural risks in the banking sector include substantial reliance on wholesale corporate deposits related to oil revenues, which may be volatile at times, continued high levels of financial dollarization, and high credit concentration. Additionally, the recent rapid growth in unsecured consumer lending could be a source of cyclical risk.

Azerbaijan's banking system appears resilient to severe adverse shocks, though there are some pockets of weaknesses. Bank solvency stress tests reveal that the banking system remains adequately capitalized under both the baseline and adverse scenarios, though some banks with thin capital buffers could face solvency pressures in the adverse scenario. In a hypothetical, extreme yet plausible adverse scenario characterized by severe global and domestic recessions coupled with a manat devaluation, the systemwide total regulatory capital ratio could decline by 4.5 percentage points, with credit risk being the main driver of losses. Eight banks out of 23, which collectively account for 35 percent of total banking sector assets, could breach the hurdle rates. However, their capital shortfalls are contained at 0.5 percent of GDP.

Similarly, banking sector liquidity buffers appear to be sufficient to withstand a severe adverse shock, though some banks appear vulnerable. Bank liquidity stress tests indicate that while the overall banking sector has sufficient capacity to withstand severe liquidity shocks, certain banks would need support. Reverse liquidity tests suggest that the banking sector could withstand manat deposit withdrawals comparable to the largest peak-to-trough outflows observed during the currency devaluations in 2015. For foreign currency, the sector could endure more than double the outflows seen in 2016. However, the high proportion of corporate deposits in some banks renders them particularly vulnerable to wholesale funding shocks, which could be aggravated by significant deposit concentration.

Commendable progress has been achieved since the 2015 FSAP, especially on banking oversight, macroprudential policies, and financial safety net. The CBA made important efforts to implement the Basel Committee on Banking Supervision's (BCBS) international standards adjusted for domestic settings, and strengthened prudential requirements, corporate governance, and risk management standards. In accordance with the Financial Sector Development Strategy (FSDS) 2024-26, the CBA is implementing the Basel III prudential standards, and has developed a new Risk-based Supervision (RBS) model based on international best practices with the first pilot starting in early 2025. The institutional framework and instruments for macroprudential policy have been considerably enhanced. The lender of last resort (LoLR) function was strengthened. Moreover, the legal, policy, and procedural framework for bank resolution were overhauled.

Some long-standing issues remain unaddressed. These include key issues repeatedly discussed in past FSAPs such as implementing a consolidated supervision framework; establishing an interagency body for crisis preparedness and management; safeguarding CBA's independence, accountability and governance; and fortifying CBA's legal resolution powers and enhancing resolution tools.

Further measures to strengthen the regulatory agenda—in addition to addressing the remaining issues—will reinforce financial sector resilience. Specifically:

- ***Regulatory oversight.*** Strengthening CBA's legal framework and enhancing governance, independence, accountability, resourcing, and supervisory approach will reinforce supervisory effectiveness. Improving the oversight of banks' corporate governance, risk management, transactions with related parties, and ownership structures will require clear frameworks for supervision, in addition to early and intrusive supervisory intervention. Establishing a comprehensive supervision cycle and early warning indicators will strengthen the prudential supervision process. Disclosure and transparency requirements for banks should also be improved.

- ***Macroprudential measures.*** Addressing data gaps and establishing an early warning system will further improve systemic risk monitoring. Expanding the macroprudential toolkit will help mitigate risks. While the current macroprudential framework is in line with good design principles, publishing a macroprudential strategy will clarify financial stability objectives and guide policy tool activation.

- ***Financial safety net.*** Further enhancements in institutional and interagency arrangements, early intervention triggers, resolution planning, deposit insurance, and emergency liquidity assistance (ELA) framework will reinforce the effectiveness of crisis preparedness and resolution. Legal authority must be given to the CBA to enable it to perform resolvability assessments and develop comprehensive policies. The resolution framework should include bank holding companies and non-regulated operational entities within the group that are significant to the group's business.

Table 1. Azerbaijan: FSAP Main Recommendations[1]

	Recommendations	Authorities	Timeline
	Systemic Risk Analysis		
1.	**Systemic risk monitoring:** Enhance the CBA's forward-looking risk assessment framework, including top-down stress testing and early warning indicators. Integrate their results into prudential policies formulation, cross-checking of banks' bottom-up stress tests, and to inform supervisory review of banks' ICAAP and ILAAP. (¶ 13, 14)	CBA	ST
	Macroprudential Policies		
2.	**Macroprudential strategy:** Develop and publish a macroprudential policy strategy. (¶ 25)	CBA	I
3.	**Capital buffer:** Enhance banks' resilience by raising capital buffer requirements consistent with Basel III, such as the capital conservation buffer, countercyclical capital buffer (including introducing positive cycle-neutral countercyclical capital buffer when suitable in line with prevailing macroeconomic and financial conditions), and differentiated high loss absorbency buffer requirements for D-SIBs. (¶ 27)	CBA	ST
4.	**Systemic risk buffer:** Adopt and activate capital buffers to address systemic risks stemming from certain sectors or specific exposures (e.g., consumer lending, FX, and concentration risks). (¶ 10, 27)	CBA	ST
5.	**Liquidity measures:** Finalize the implementation of Basel III liquidity requirements, including the NSFR; and regularly publish aggregate data on LCR and NSFR once implementation is completed. (¶ 27)	CBA	ST
6.	**De-dollarization measures:** Widen the relatively narrow wedge between required reserves on manat and FX deposits to strengthen FX liquidity buffers and limit the intermediation of FX deposits. (¶ 28)	CBA	ST
	Banking Supervision and Regulation		
7.	**Central bank's powers, independence, accountability and governance:** Amend the Law on Central Bank of Azerbaijan in line with international best practices in central banking and BCP (CP1 and CP2 criteria) by making explicit the primary objective of banking supervision; enhancing the CBA's legal provisions and procedures which underpin accountability; and reinforcing CBA's institutional framework by completing the implementation of the 2015 FSAP and 2022 development module FSAP recommendations on powers, independence and governance. (¶ 32)	CBA / Parliament	MT
8.	**Corrective and sanctioning powers:** Enhance the regulatory framework to ensure clarity of corrective actions and sanctions powers, which allow the CBA to act at an early stage to address unsafe and unsound practices and to use these sanctioning powers more proactively. (¶ 32)	CBA	ST
9.	**Early intervention:** Develop a rigorous and structured internal framework and guidelines for a consistent and early supervisory intervention, and a clear escalation process of corrective actions. (¶ 32)	CBA	ST
10.	**Transactions with related parties:** Enhance the enforcement measures imposed by the CBA (including sanctioning and other prudential requirements) in cases of material shortcomings on transactions with related parties' provisions, in order to discourage these misconducts in banks. (¶ 30)	CBA	ST
11.	**Disclosure and transparency:** Issue requirements to encourage banks to disclose data on the group they belong to, as well as their structure of ownership (and beneficial owners) and more comprehensive and structured information on exposures of transactions to related parties. (¶ 32)	CBA	ST
12.	**Consolidated supervision**: Expedite the implementation of strategic projects that include legal amendments and prudential requirements to ensure full adoption of a consolidated supervision framework. (¶ 31)	CBA	ST
13.	**Integration of risk assessment:** Issue requirements to integrate ICAAP and ILAAP into banks' risk management framework and supervisory review process to ensure a comprehensive assessment of solvency and liquidity risks. (¶ 32)	CBA	ST
	Financial Safety Net, Bank Resolution and Crisis Management		
14.	**Recovery planning:** Efficiently integrate bank recovery plans into CBA's Supervisory Review Process and early intervention framework and enhance the Methodological Guidance on Recovery Plans. (¶ 40)	CBA	ST

Table 1. Azerbaijan: FSAP Main Recommendations (concluded)			
	Recommendations	**Authorities**	**Timeline**
15.	**Insolvency and liquidation, resolution planning, and bank resolution:** Amend the Law on Banks, in line with FSB Key Attributes, by extending the scope of the resolution framework; including resolution objectives, forward-looking resolution and governance triggers; making explicit CBA's power to apply resolution powers immediately for banks deemed non-viable/ likely non-viable; empowering CBA to use its resolution powers without a requirement for court approval and to impose a moratorium without any court approval; sufficiently reflecting the "no creditor worse off than in liquidation" (NCWL) principle; ensuring that insured depositors are protected in the resolution regime liquidation options; and making explicit that temporary public ownership should be an exceptional mechanism used as a last resort to maintain financial stability. (¶ 39)	CBA, MOF, Parliament	ST
16.	**Resolution plans:** Prepare resolution plans for D-SIBs and banks that are assessed to provide critical economic functions and whose failure would have systemic consequences. (¶ 39)	CBA	I
17.	**Emergency Liquidity Assistance (ELA):** Establish a comprehensive ELA framework, including eligibility criteria and collateralization requirements. (¶ 39)	CBA	I
18.	**Deposit Insurance, resolution funding and temporary public funding:** Amend the Law on Deposit Insurance to absolve the requirement for coordination with the President (in line with IADI CP3); empower ADIF to conduct on-site examinations; grant paybox-plus mandate to ADIF; enable ADIF to first and foremost increase industry contributions when there is a probability that funds will run low; make ADIF borrowing from the CBA, under government indemnity, a source of emergency funding; and empower the MOF to provide ADIF with a clear back-up emergency funding where the resources are insufficient. (¶ 39, 41)	ADIF, CBA, MOF, Parliament	ST
	Financial Integrity		
19.	**AML/CFT:** Strengthen the AML/CFT risk-based supervision framework, and address other deficiencies identified by MONEYVAL. (¶ 35)	CBA	ST
	Systemic Liquidity Management		
20.	**Money market:** Promote the development of markets for interbank repo, unsecured market, and government securities to boost market capacity to withstand shocks and enhance financial sector resilience. (¶ 37)	CBA, MOF	ST
21.	**Short-term liquidity management:** Adjust the payment timeframe (duration where the borrowed money is returned to the central bank or commercial banks when the lending/deposit facility is used) to support a smooth operation of the lending and deposit facilities. (¶ 38)	CBA	ST

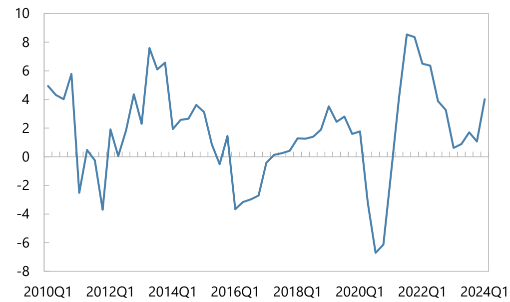
[1] Timing: I–Immediate: within 1 year; ST–short term: 1 to 3 years; MT–medium term: 3–5 years

BACKGROUND

A. Context and Macrofinancial Developments

1. **Azerbaijan's economic growth rebounded in 2024 (Figure 1).**[1] Growth picked up in 2024 after moderating in 2023, driven by non-hydrocarbon construction and services (Table 2). In the medium term, growth is projected at around 2½ percent, in line with potential. Regional conflicts and uneven global growth pose risks to the outlook. Inflation rose slightly following a recent increase in some energy and regulated prices but is projected to remain within the official target range (4±2 percent) in the medium term. While high oil prices boosted government revenues, moderate fiscal spending growth will underpin higher fiscal and current account surpluses, and international reserves.

Real GDP Growth
(In Percent, Y/Y)



Source: State Statistical Comittee of Azerbaijan and Haver Analytics.

2. **Bank credit growth has tapered and has been overtaken by nonbank credit institutions, while private debt levels are on the rise, suggesting a late stage in the credit cycle (Figure 2).** Total domestic credit grew by around 24 percent (y/y) in July 2024, higher than the average annual rate of 18 percent (y/y) over the past three years. Household debt—while still low at 9 percent of total GDP—has increased slightly above pandemic levels, largely driven by rising consumer loans, of which more than half are attributable to public sector employees and pensioners.[2] This led to an elevated household debt-to-income ratio, indicating a potential buildup of imbalances. Leverage in the nonfinancial corporate sector (excluding oil and gas) has also risen post-pandemic.

3. **The financial sector has emerged resilient from the COVID-19 pandemic, but pockets of vulnerabilities remain**. The banking sector's financial soundness indicators are in line with most regional peers (Figures 3 and 4) as government support measures have helped cushion the impact from the pandemic (Table 5). As of July 2024, banks' capital adequacy ratio stood at 17.5 percent (Table 3).[3] The Liquidity Coverage Ratio (LCR) requirement is being phased in—starting December 2023—and is currently at 128 percent. All banks have successfully met the transitional requirements

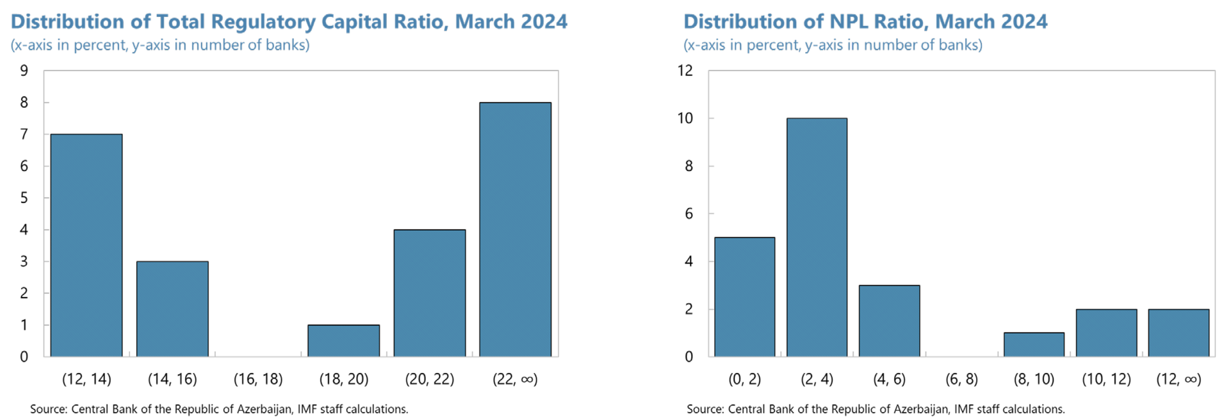
[1] Azerbaijan is an emerging economy characterized by a large oil and gas sector (50 percent of GDP) with a *de facto* fixed exchange rate regime. International reserves at the CBA account for 8.5 months of the projected 2024 imports. Combined CBA and the State Oil Fund of Azerbaijan (SOFAZ) reserves reached $66 billion (about 53 months of projected 2024 imports).

[2] Although household leverage is relatively low compared to other emerging economies, it comprised more than 50 percent of private sector credit.

[3] The retreat from the 2020 peak reflects tighter prudential measures on consumer loans, inclusion of market and operational risks in risk-weighted asset calculations, and unwinding of pandemic-related regulatory forbearance. The effects of these factors have fully materialized; all pandemic-related measures have been completely phased out.

for June 2024 (18 out of 22 banks already reported levels above 100 percent in July 2024).[4] Asset quality has improved considerably as legacy risks subside. The aggregate nonperforming loan (NPL) ratio declined from its peak of 21 percent at end-2016 to 2.7 percent in July 2024, while restructured loans trended lower after an uptick during the pandemic.[5] Overall, the banking sector remains profitable, supported by wide interest margins. However, some banks—including some domestic systemically-important banks (D-SIBs)—have thin capital buffers, while the NPL ratio shows significant variation across individual banks.

Azerbaijan: Distributions of Capital and Nonperforming Loans



4. Downside risks to the outlook remain. A sharp decline in oil and gas prices or an intensification of regional conflicts could adversely impact the domestic economy, including banks' asset quality and liquidity (Table 6). Domestic risks—including procyclical fiscal policies, weak state-owned enterprises, and extreme climate events—could amplify losses during stress periods.

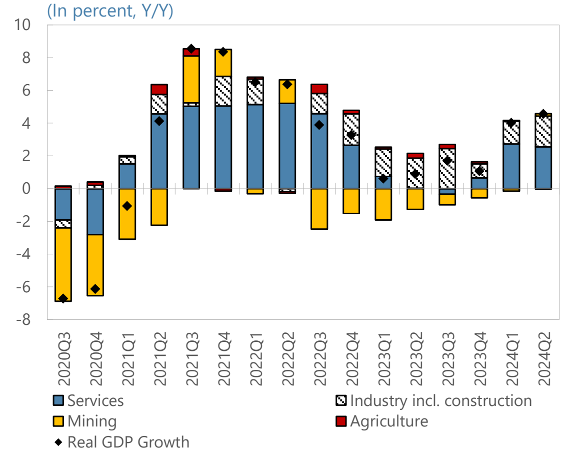
[4] Transitional minimum requirements for June 2024—for aggregate and foreign currency—are 80 percent for D-SIBs and 70 percent for non-D-SIBs; with increases of 10 percentage points every six months until they reach 100 percent.

[5] The reduction in NPLs can be attributed to the clean-up of the banking sector and financial reforms following the 2015-2016 crisis, including the sale of NPLs (Box 1), NPL resolution program in 2019 (involving compensation by the government to pay down overdue retail loans), liquidation of troubled banks over the years, and write-offs by banks.

Figure 1. Azerbaijan: Recent Economic Development

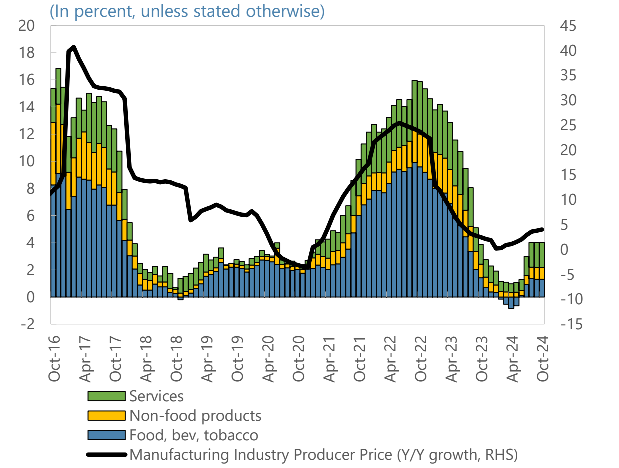
Growth picked up in 2024, driven by stronger services and construction activities…

Quarterly Sectoral Contributions to Growth
(In percent, Y/Y)



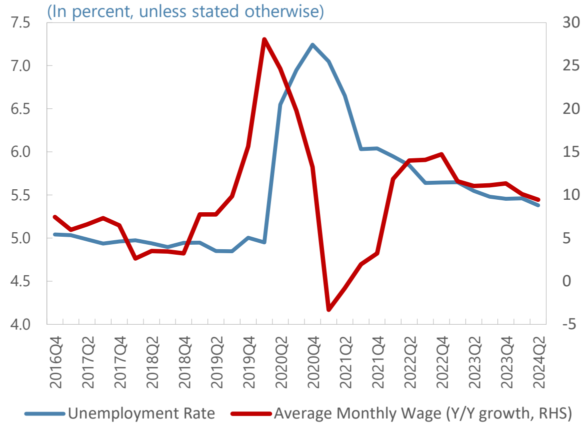
… prompting prices to rise slightly

Contributions to Headline Inflation, Y/Y EOP
(In percent, unless stated otherwise)



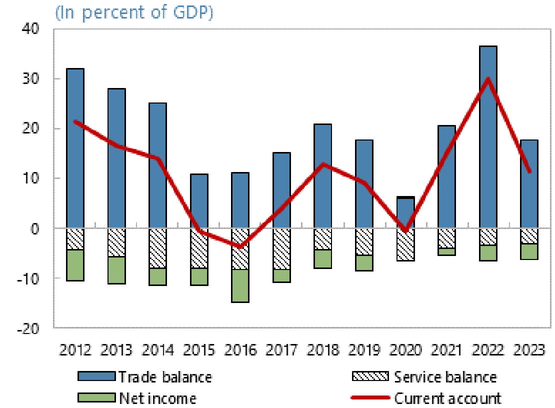
Labor market continued to stabilize post-pandemic…

Unemployment Rate and Wages
(In percent, unless stated otherwise)



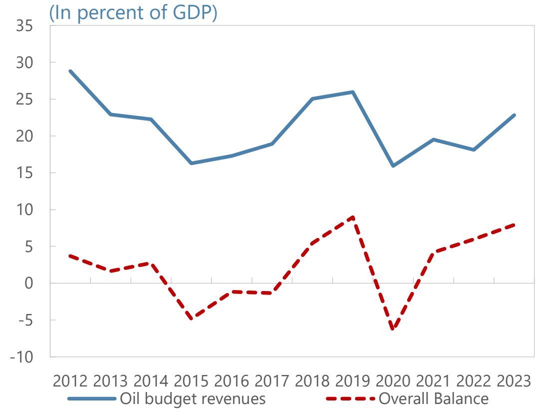
… while external current account remained in surplus, driven by oil and gas exports

Current Account
(In percent of GDP)



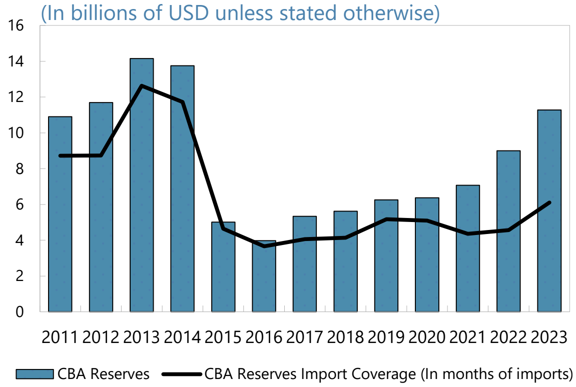
Hydrocarbon revenues continue to underpin fiscal surplus …

Overall Balance and Oil Budget Revenues
(In percent of GDP)



… supporting the accumulation of substantial international reserves

Gross Official Reserves
(In billions of USD unless stated otherwise)



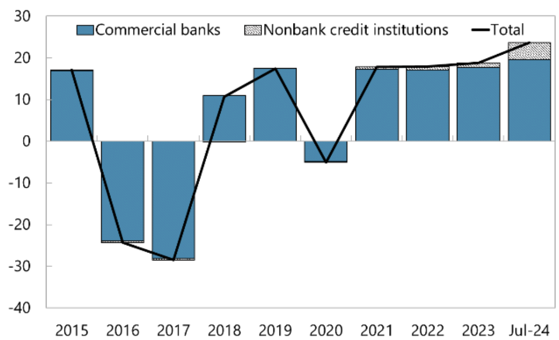
Sources: National authorities, Haver, and IMF staff computation.

Figure 2. Azerbaijan: Domestic Credit, Debt, and Real Estate Developments

Private credit continued to grow, led by nonbank credit …

Domestic Credit Growth by Type of Institution

(y/y contribution to growth, y/y percent change)

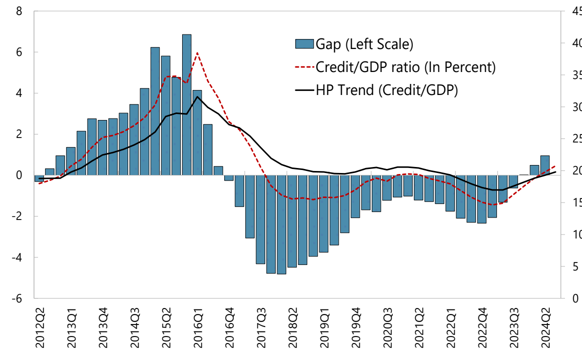


Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.
Note: Domestic credit refers to loans to the nonfinancial sector.

…prompting a widening of the positive credit-to-GDP gap

Credit-to-GDP: Ratio and Gap

(Percentage points, factor augmented HP filter)

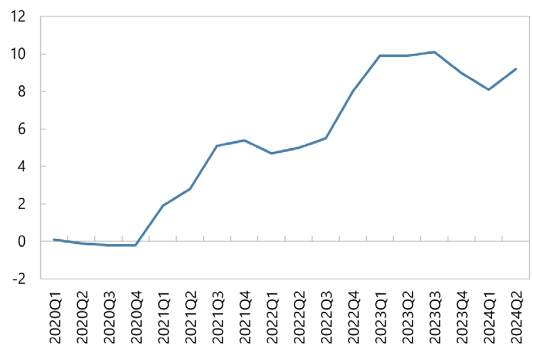


Sources: Central Bank of Azerbaijan, Haver Analytics, and IMF staff computations

Growth in residential property prices resumed after falling in 2023…

Residential House Price Growth

(In percent, Y/Y)

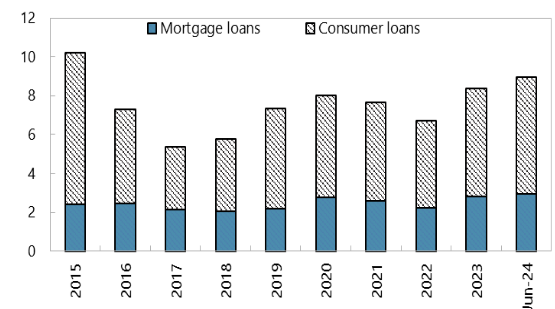


Source: State Statistical Committee of the Republic of Azerbaijan, IMF staff calculations.

Household debt rose above pre-pandemic, albeit still low…

Household Debt

(Percent of GDP)

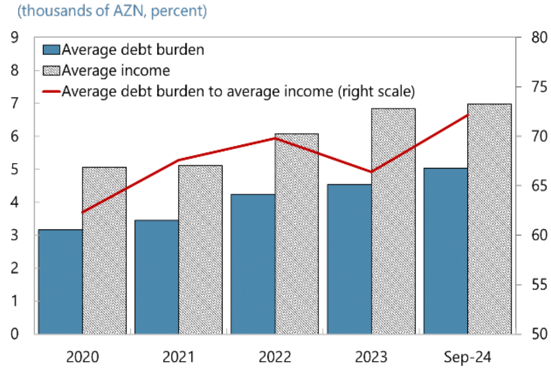


Sources: Central Bank of Azerbaijan and IMF staff computations

…leading to an elevated household debt-to-income ratio…

Household Debt-to-income Ratio

(thousands of AZN, percent)

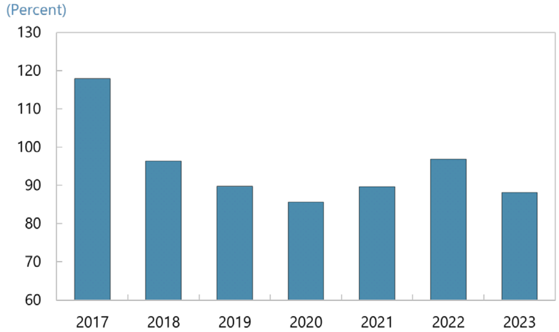


Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.
Note: Household debt refers to loans extended by banks and nonbank credit institutions.

… while corporate leverage rose post-pandemic

Nonfinancial Corporate Debt-to-equity Ratio

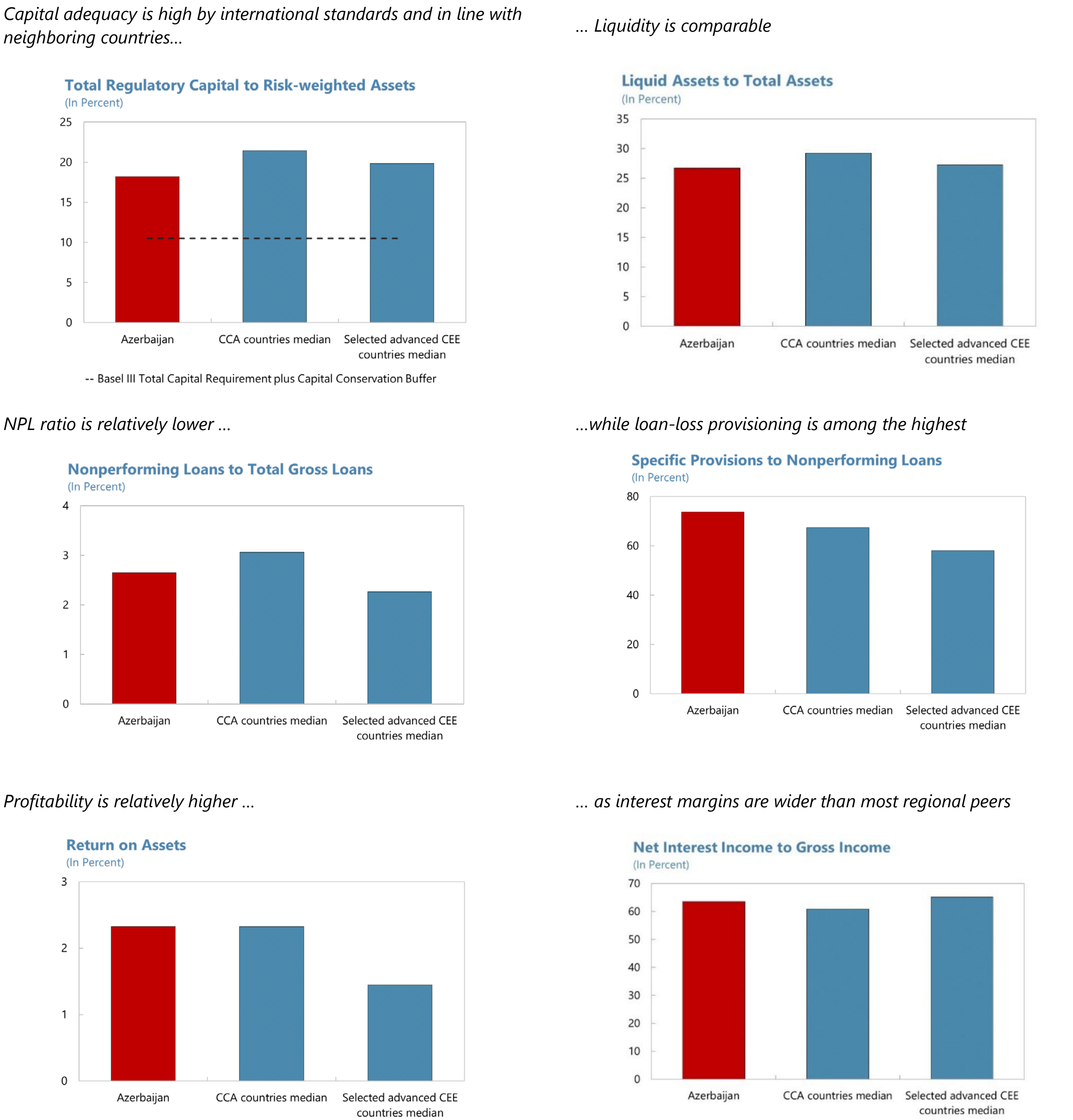
(Percent)



Sources: State Statistical Committee of the Republic of Azerbaijan, IMF staff calculations.
Note: Excludes oil and gas sector.

Figure 3. Cross-Country Comparison of Banking Sector Financial Soundness Indicators, Q1 2024[1,2]

(In Percent)



Source: IMF Financial Soundness Indicators.

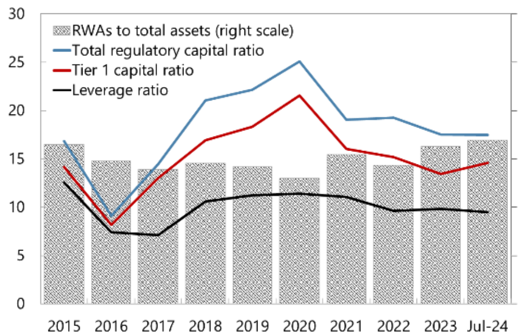
[1] Caucasus and Central Asia (CCA) countries include Azerbaijan, Armenia, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, and Uzbekistan; selected advanced Central and Eastern European (CEE) countries include Czech Republic, Hungary, and Poland.

[2] Latest available data for Armenia and Tajikistan as of 2023Q2 and 2021Q4, respectively.

Figure 4. Azerbaijan: Recent Developments in the Banking Sector

The retreat in capital ratios from the 2020 peak was mainly due to strengthened regulations...

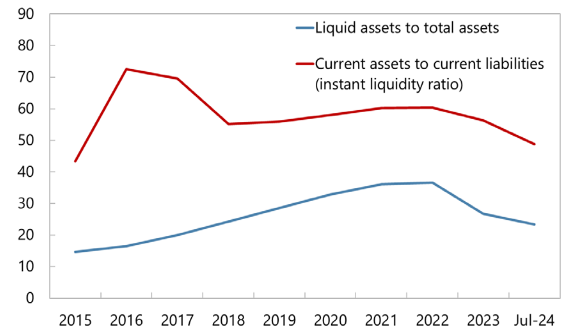
Capital Adequacy
(In percent)



Source: Central Bank of the Republic of Azerbaijan.

...while liquidity declined slightly as banks placed excess cash holdings with the CBA following higher reserve requirements

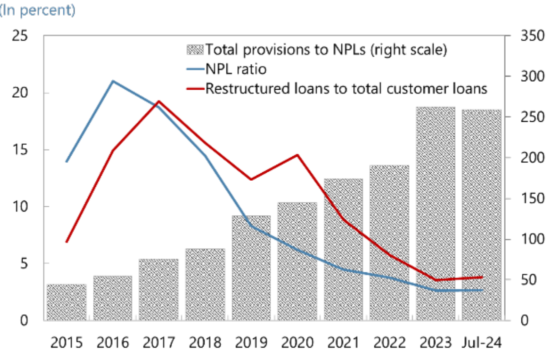
Liquidity
(percent)



Source: Central Bank of the Republic of Azerbaijan.
Note: Required reserves held at the CBA are not classified as liquid assets.

NPLs and restructured loans have declined but loan-loss provisions remained high due to strict prudential measures

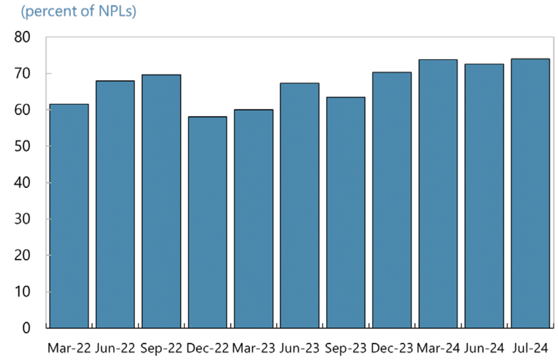
Asset Quality
(In percent)



Source: Central Bank of the Republic of Azerbaijan.

Specific provisions to NPLs are also high

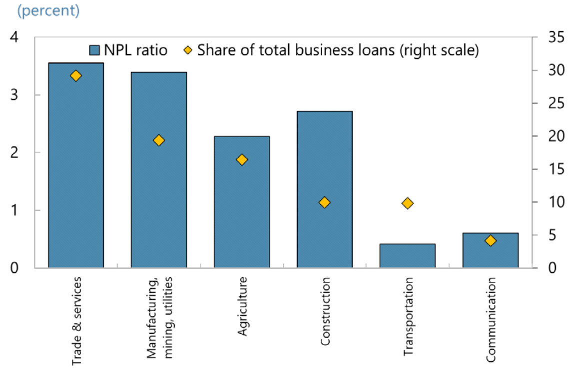
Specific Provisions for NPLs
(percent of NPLs)



Source: IMF Financial Soundness Indicators, Central Bank of the Republic of Azerbaijan.
Note: Reliable data on specific provisions available only since 2022.

NPL ratios are relatively higher in trade and services, manufacturing, and construction...

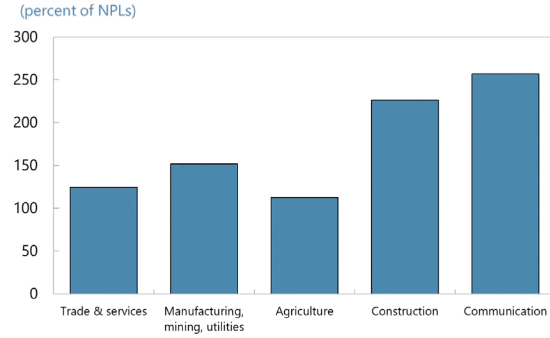
NPL Ratio for Business Loans by Sector, July 2024
(percent)



Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

...but, total provisions remain high, exceeding 100 percent of NPLs across all sectors

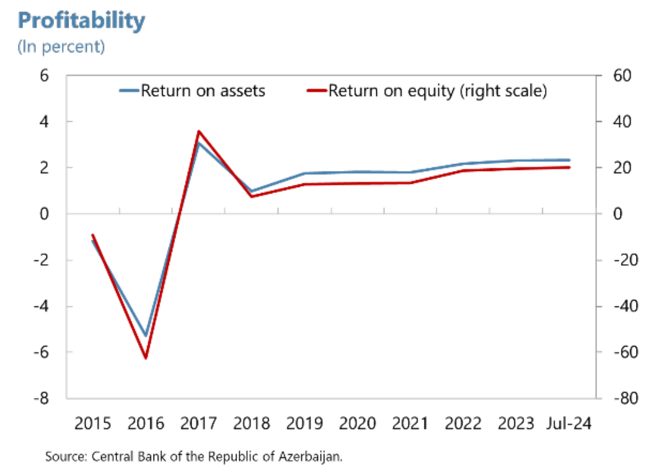
Total Provisions for Business Loans by Sector
(percent of NPLs)



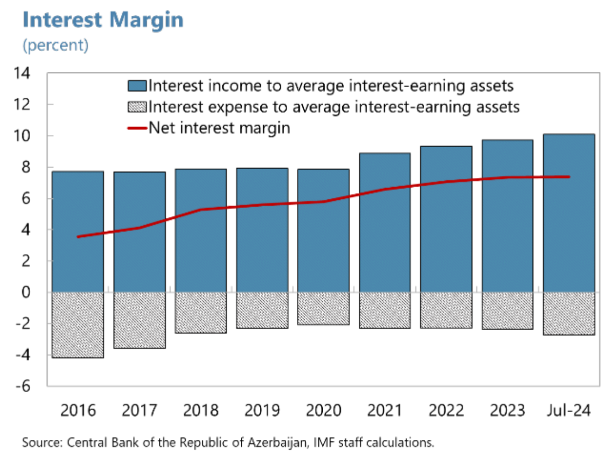
Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.
Note: The ratio for the transportation sector has been excluded from this chart due to its significantly high value, which would distort the scale if included.

Figure 4. Azerbaijan: Recent Developments in the Banking Sector (concluded)

Profitability continued to increase…



…supported by widening interest margins



B. Financial Sector Landscape

5. Azerbaijan's financial system is small and dominated by banks (Table 4). Total financial system assets represented 61 percent of GDP in 2023. Commercial banks account for two-thirds of the financial system. Five D-SIBs collectively hold ¾ of total banking sector assets. Foreign-controlled banks are small. Banks' activities are domestically oriented, with limited cross-border exposures.[6] Sanctions have reduced correspondent banking relationships with Russian banks. A few banks have correspondent accounts with US banks, while some have accounts with banks from Austria, Türkiye, Georgia, China, and Kazakhstan.[7]

6. Banks hold sizeable liquid assets and prefer shorter-term lending as they lack stable funding (Figure 5). As of July 2024, 88 percent of banks' total nonfinancial customer deposits have a maturity of less than one year. About 60 percent of these deposits are volatile wholesale deposits from large businesses—posing funding risks—prompting banks to resort to short- to medium-term lending. The average loan maturity is only 2.2 years. To encourage customers' deposits of 18 months or longer, a recent tax incentive grants 3 years of tax free interest on deposits with these maturities. Banks hold a sizeable (⅓ of total assets) in liquid assets—including cash, excess reserves at the CBA, nostro accounts and deposits in other FIs, and investments in sovereign bonds—to ensure sufficient cash buffers in the event of large business deposit withdrawals.[8]

[6] In 2020, four banks (5 percent of banking assets) were liquidated due to long-standing solvency issues.

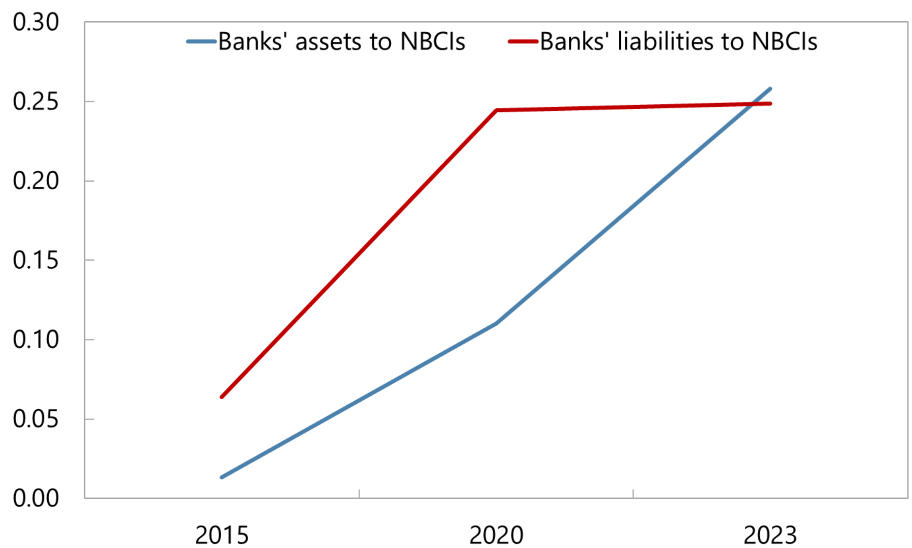
[7] Recently, a D-SIB started correspondent banking relationship with a large US custodian bank.

[8] Risks from sovereign-bank nexus are limited considering the sizeable fiscal buffers.

7. Nonbank financial intermediation (NBFI)—⅓ of financial system assets—is dominated by state-owned specialized institutions. About 40 percent of total assets within NBFI comprised distressed assets—mostly from International Bank of Azerbaijan (Box 1)—transferred to Aqrarkredit, a state-owned nonbank credit institution (NBCI). The State Social Protection Fund (pension fund) holds ¼ of total NBFI assets, while another three state-owned development funds collectively represent 20 percent of the total. The Mortgage and Credit Guarantee Fund (MCGF)—the largest development fund—supports affordable housing and offers guarantees and interest subsidies to small and medium-sized enterprises. It is profitable and has strong operating performance.[9]

8. Other private NBCIs are relatively small (1 percent of financial system assets). They are exposed to FX risks as their FX liabilities exceed FX assets and are interconnected—to a relatively small extent—with banks through borrowing and deposit placements (Figure 12). To mitigate risks, prudential regulations were tightened.[10] Additionally, NBCIs are required to establish audit and supervisory committees to strengthen corporate governance.

Banks' Interlinkages with NBCIs
(percent of total banking sector assets)



Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.
Note: NBCIs include Aqrarkredit.

[9] Fitch Ratings revised MCGF's credit outlook on February 21, 2023 to BB+/Positive from BB+/Stable based on solid government support and strong operating performance.

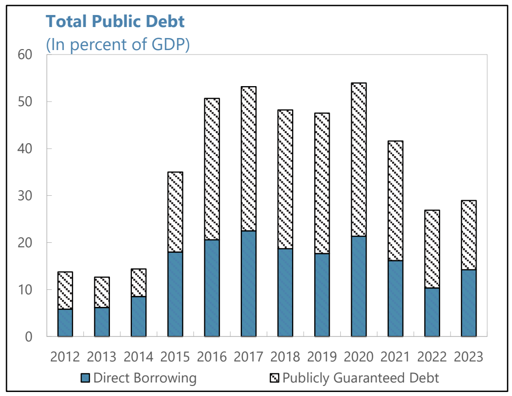
[10] Including minimum capital of AZN1 million from AZN0.3 million; minimum leverage ratio of 10 percent; lending limits; and loan-loss provision.

Box 1. Azerbaijan: Rehabilitation of International Bank of Azerbaijan (IBA)[1]

Azerbaijan's largest and state-owned bank, IBA, was bailed out following the 2015-2016 economic downturn, which, coupled with several idiosyncratic factors related to its business operations, resulted in high NPLs and large FX valuation losses.[2] Measures totaling 37 percent of GDP included:

- The transfer of about AZN15 billion of distressed assets at face value to Aqrarkredit, pursuant to the July 15, 2015 Presidential Decree, financed through the sale of Aqrarkredit's government guaranteed bonds to CBA;
- A restructuring of USD3.3 billion of foreign currency liabilities, including exchanging USD1 billion in deposits of SOFAZ with bonds issued by IBA; and
- A capital injection of AZN600 million by the government.

To acquire and manage the distressed assets, Aqrarkredit issued a total of AZN10 billion in bonds guaranteed by the government and subscribed by the CBA. In 2017, Aqrarkredit repurchased AZN518 million of its bonds from the CBA and has been timely in its repayments. The guarantee on these bonds is officially recognized in the general government debt. According to the 2023 Article IV debt sustainability assessment, the overall, near-, and medium-term risks of sovereign stress are low under the baseline scenario. Despite having resolved only about one-third of the assets, Aqrarkredit managed to remain profitable.



IBA's financial soundness indicators have improved since the 2015 crisis (Figure 6).

1/ In 2015, IBA held 38 percent of total banking sector assets. This share has declined to 26 percent as of July 2024. Aqrarkredit is fully funded by the government.

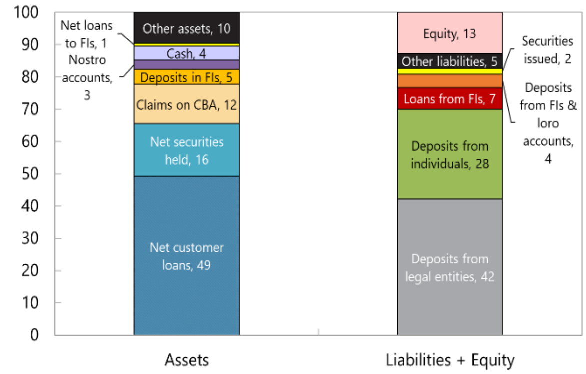
2/ Findings from the 2015 FSAP indicated that IBA provided loans at discounted interest rates to companies and projects prioritized in government developmental programs, and additional loan to large borrowers. The mixed operational approach to lending and below-market cost of subordinated capital masked the true policy cost of the perceived developmental mandate of IBA.

Figure 5. Azerbaijan: Structure of the Banking Sector

Banks focus on traditional intermediation activities

Aggregate Balance Sheet, July 2024

(percent of total)

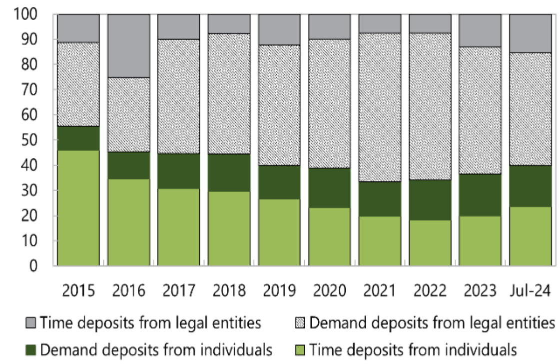


Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

The share of chunky business deposit is substantial…

Deposits by Type and Counterparty

(percent of total)

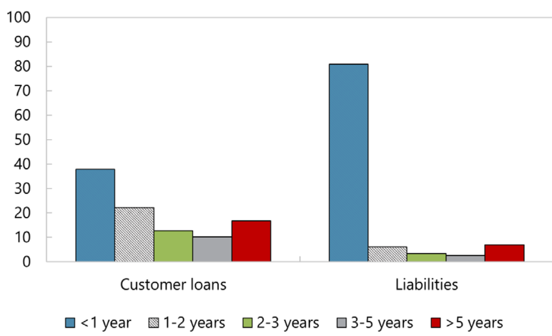


Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

…and the lack of long-term funding constrains banks' lending options

Maturity Profile of Loans and Liabilities, July 2024

(In percent of total)

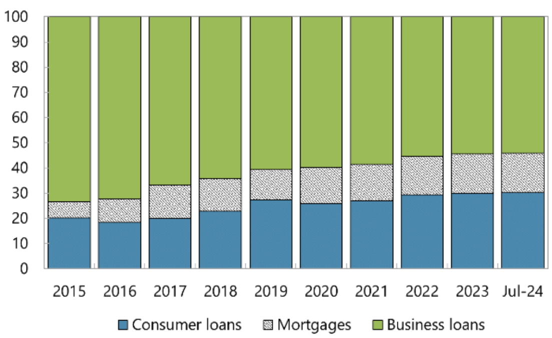


Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

…resulting in growing exposure to short term consumer credit

Loans by Segment

(percent of total)

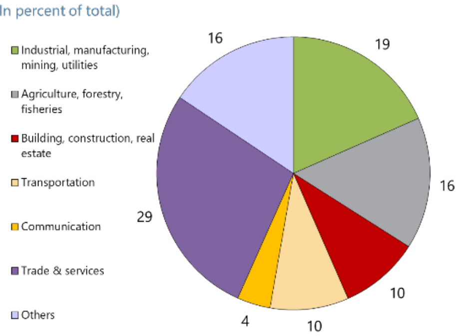


Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

Business loans are largely to the trade and services sector

Business Loans by Sector, July 2024

(In percent of total)

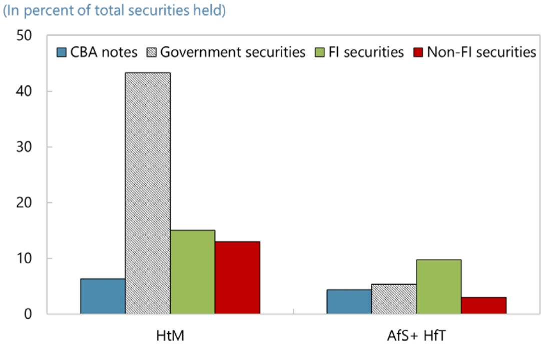


Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

Nearly 80 percent of investments are held to maturity

Securities Holdings by Type and Instrument, July 2024

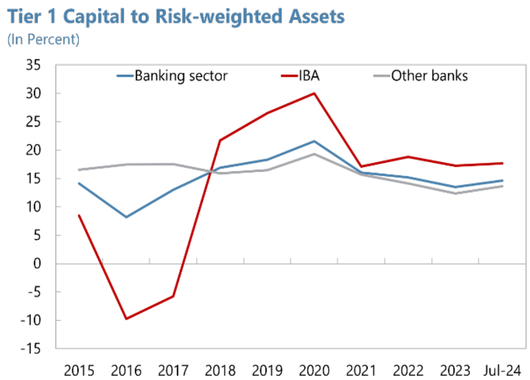
(In percent of total securities held)



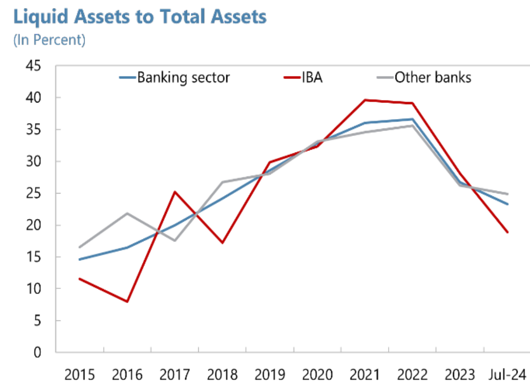
Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

Figure 6. Azerbaijan: Financial Soundness Indicators of International Bank of Azerbaijan
(In Percent)

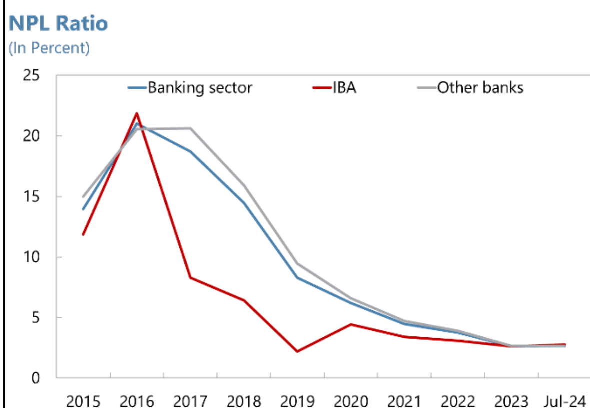
IBA outperforms the sector in terms of capital adequacy…



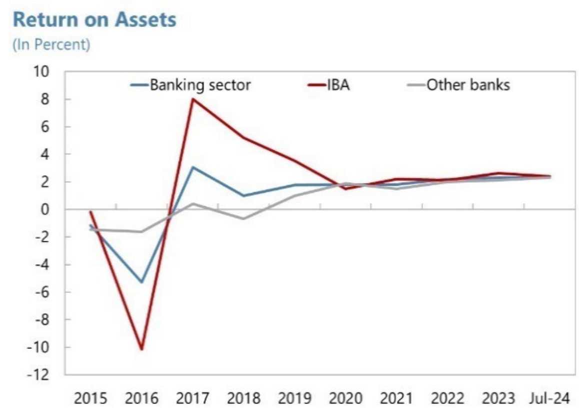
…but its liquidity position is slightly lower



NPL ratio is in line with the aggregate level…



…as is profitability



Source: Central Bank of the Republic of Azerbaijan.

9. **Inter-sectoral analysis highlights banks' dominance as intermediaries in Azerbaijan's financial system.** Nonfinancial corporations (NFCs) and households are the main net suppliers of funds to banks through deposits. Large and sudden withdrawals of these deposits expose banks to liquidity risk. The nexus between government and financial institutions (FIs) primarily stems from FIs' investments in government debt securities and state ownership of these institutions (Figure 7). The vulnerability of NFCs to FX shocks—especially those with unhedged exposures—pose credit and liquidity risks to banks through NFCs' borrowings from, and deposit placements with, banks.[11] Given their domestic focus, banks have limited net claims on nonresidents. Claims on foreign countries are largely in the form of nostro accounts and deposit placements with counterparties in the United States, while banks' liabilities to foreign countries are mainly to Russia.

[11] There are data gaps in NFC's exposure to nonresidents, derived from IMF's Balance Sheet Approach. Anecdotal evidence suggests that some large NFCs have significant external borrowings.

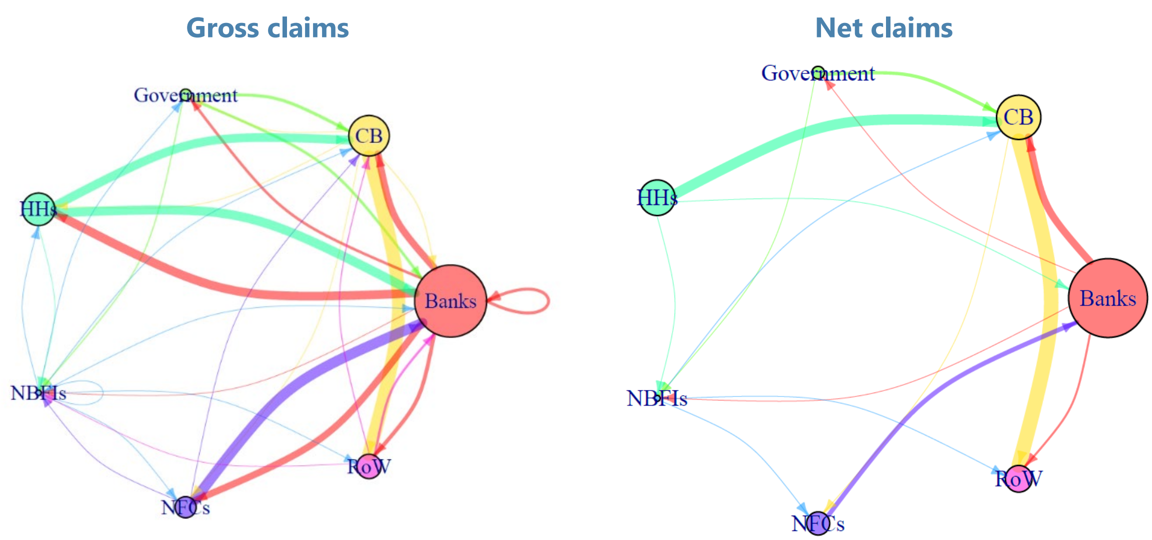
Azerbaijan: Sectoral Balance Sheet Matrix, 2023
(In Percent of GDP)

ASSETS OF: \ LIABILITIES OF:	Government	Central Bank	Banks	NBFI	Nonfinancial Corporations	Households	External
Government		4.02	3.51	1.51			
Central Bank 1/	0.28		1.13	0.00	0.03		18.82
Banks	3.57	9.56	4.04	0.87	9.39	12.24	5.21
NBFI 2/	0.66	0.04	0.77	0.24	0.46	0.49	0.11
Nonfinancial Corporations		0.00	14.63	0.37			
Households		12.18	12.80	0.53			
External		1.52	3.00	0.04			

0-0.5 0.5-1.5 1.5-9 9+ In-sector exposures

Source: IMF Balance Sheet Approach (BSA) database.
1/ Central bank's liabilities to households represent currency in circulation
2/ Nonbank Financial Intermediation (NBFI) excludes Aqrarkredit

Figure 7. Azerbaijan: Cross-Sectoral Exposures Map



Note: CB = Central Bank; NBFI = Nonbank Financial Intermediation; HH = Household Sector; NFC = Nonfinancial Corporations; ROW = Rest of the World. The direction of arrow represents flow of funds. The size of edge is proportional to the size of bilateral exposures and the size of node is proportional to gross exposures of that sector in the system.

Sources: IMF Balance Sheet Approach (BSA) database and IMF staff calculations.

SYSTEMIC RISK ASSESSMENT[12]

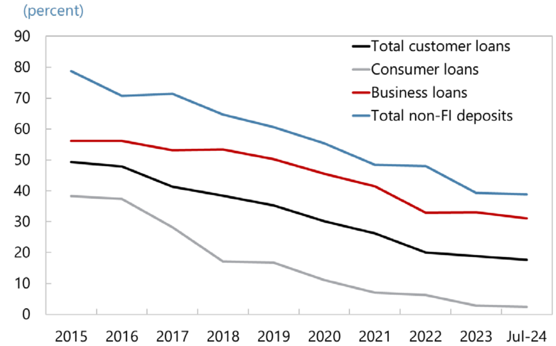
A. Financial Sector Vulnerabilities and Risks

10. Azerbaijan's banking sector is exposed to liquidity, FX, concentration, and credit risks.[13] Specifically:

- **Funding risks are high.** The share of wholesale deposits from corporates is substantial, predominantly in demand deposits that are inherently volatile, often linked to bulky oil export receipts.[14] The uneven distribution of liquidity and under-development of domestic financial markets—characterized by thin market liquidity—could reduce banks' resilience to large liquidity shocks. The CBA's standing facilities could provide some cushion, and the ELA could serve as a backstop—as a last resort—for solvent and viable banks experiencing temporary liquidity shortages. However, the ELA framework requires enhancements as its operational aspects remain untested. The FSAP's funding concentration analysis revealed that 10 banks—including three D-SIBs—could face liquidity strains in a hypothetical adverse scenario where their five largest deposits were withdrawn simultaneously. To address liquidity risks that are specific to certain banks, the CBA could impose Pillar 2 liquidity "add-on" to complement the LCR.

- **Elevated financial dollarization.** Since its peak following the manat devaluations in 2015, overall dollarization has been steadily declining. However, it remains high for business loans[15] and overall deposits (at 31 and 39 percent as of July 2024, respectively), thus exposing banks to FX-induced credit and liquidity risk.[16] As of July 2024, 36 percent of foreign currency business loans—largely directed to the industrial and manufacturing sectors—were attributable to unhedged borrowers. Strengthening communication and recalibrating some macroprudential tools to promote the use of domestic currency would support further de-dollarization.

Dollarization
(percent)



Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

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[12] Detailed methodology on the stress test can be found in the technical note of the systemic risk analysis.

[13] Stress tests in the next section provide further details.

[14] Individual and entrepreneur deposits comprise 30 percent of total banking sector liabilities; 90 percent of them are covered by deposit insurance.

[15] Risk weight on unhedged FX business loans increased from 120 to 200 percent since 2022.

[16] According to Della Valle et al. (2021) and Gondo, R. et al. (2020), one estimate of natural level of deposit dollarization for Azerbaijan is around 13 percent.

- **High credit concentration.** Banks' large exposures comprised 76 percent of Tier 1 capital in July 2024. The five largest bank credit exposures amounted to 63 percent of aggregate Tier 1 capital, with individual banks' exposures ranging from 13 percent to more than twice their Tier 1 capital. Some banks are in breach of the large exposure and related party transaction limits, although the number of cases has declined over the past five years. To limit these risks, the CBA has amended relevant regulations to refine the definition of a related party, established collateral requirements, improved prudential reporting, and imposed deadlines for addressing existing violations.

- **Rapid growth in unsecured consumer lending.** Consumer credit has been growing rapidly at an average annual rate of 21 percent over the 2018-2023 period, driven primarily by unsecured personal loans. In response, the CBA tightened several prudential measures in 2022 to moderate its growth and increase banks' buffers. The NPL ratio for consumer loans declined from the peak of 28 percent in 2017 to 2.8 percent in 2023, before picking up slightly to 3.1 percent in July 2024. While half of the consumer loans originated from public sector employees, 30 percent of the total came from vulnerable borrowers with debt-to-income ratio exceeding 60 percent. To mitigate these risks, the CBA increased sectoral risk-weights (RWA)[17] and tightened borrower-based measures on consumer loans, including putting a cap on the debt-to-income (DTI) ratio at 70 percent and limits on the loan-to-value (LTV) ratio for residential property loans.[18] Implementing sectoral buffers would complement these borrower-based measures.

Consumer Loans
(billions of AZN, y/y percent change)

Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

B. Risk Analysis Framework and Macrofinancial Scenarios

11. The FSAP conducted top-down bank solvency and liquidity stress tests, and domestic contagion simulation to assess the resilience of the financial system (Appendix I). These analyses were conducted at bank level using supervisory data as of March 2024.[19] Findings suggest that Azerbaijan's banking system remained adequately capitalized in both baseline and adverse scenarios although some banks—including D-SIBs—could face solvency pressures in the adverse scenario. Bank liquidity stress tests indicate that while the overall banking sector has sufficient capacity to withstand severe liquidity shocks, certain banks need reinforcement.

---

[17] RWA of 100% for DTI≤45%; 200% for 45%<DTI ≤60%; and 230% for 60%<DTI ≤70%.

[18] LTV for residential property loans (secured by the same property) for borrowers that do not own any other residential property is 85%. LTV on any other type of mortgage loans is 70%.

[19] Data on a consolidated basis were not available. The introduction of a supervision framework and prudential reporting on a consolidated basis are planned as part of the FSDS.

Bank Solvency Stress Test

12. The solvency stress test was performed under baseline and extreme but plausible adverse scenarios, across a three-year horizon. Specifically:

- ***The Baseline scenario*** is aligned with the IMF's April 2024 WEO and Article IV's projections of GDP and inflation in May 2024 (Figure 8). Under this scenario, global economic activity would remain resilient, with oil prices projected to decline but stay moderately elevated. Domestic economic growth was projected at 2.3 percent in the medium term, primarily driven by the non-oil sector as the hydrocarbon GDP shrinks gradually due to the structural decline in oil production. Inflation was expected to remain within the CBA's target range of 4±2 percent, and the de facto peg to the US dollar was assumed to be maintained.

- ***The Adverse scenario*** featured an abrupt global recession, triggering a plunge in oil and gas prices by about 50 percent below the baseline by 2025. The deterioration in external and fiscal positions—along with eroding business and consumer confidence—would lead to a contraction in the domestic economy.[20] The manat was assumed to devalue by 30 percent against the US dollar to restore external balance.[21] The weaker currency would, in turn, pass through to higher domestic prices, prompting monetary policy tightening, which increases the average interbank rate by 480 basis points relative to the initial level at its peak.

Results

13. Under the baseline scenario, systemwide capital ratios remained strong and one small bank breached its hurdle rates (Figure 9, Panel 1). The small bank—which has an initial low capital level and weak profitability—comprises less than 1 percent of total banking assets.[22]

[20] The sharp declines in oil prices and non-oil GDP trajectory closely resemble the 2015-2016 crisis. A two-year cumulative decline in real non-oil GDP of 5.5 percent corresponds to 1.8 standard deviations below the historical mean (slightly less than the two-standard deviation rule-of-thumb typically applied in standard stress testing) due to the highly volatile non-oil GDP in the past, mostly on the upside.

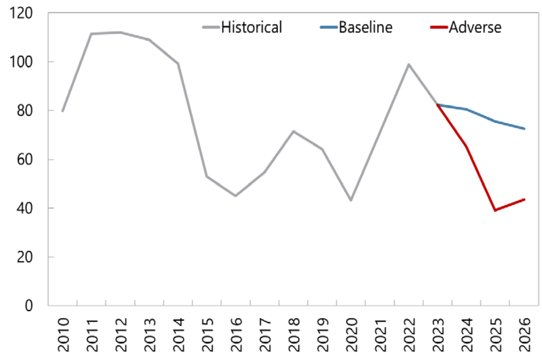
[21] The devaluation assumption has a low likelihood of materializing, given the large current account surpluses and international reserves. This assumption was made to assess banks' resilience to FX risk in the context of elevated financial dollarization and extreme events. Additionally, the recessionary scenario necessitates the devaluation assumption for the interest rates to increase, which is critical in assessing vulnerabilities stemming from banks' negative interest rate gap.

[22] A bank is deemed undercapitalized if any of its projected total regulatory capital, Tier 1 capital, or leverage ratios fall below 10, 5, or 4 percent (12, 6, and 5 percent for D-SIBs), respectively. It would also be deemed undercapitalized if its total regulatory capital breaches the minimum requirement of AZN50 million. The CCyB requirement—set at zero until March 1, 2025—is assumed to remain unchanged. Capital conservation buffer has not been implemented.

Figure 8. Azerbaijan: Projections of Key Macrofinancial Variables Under Baseline and Adverse Scenarios

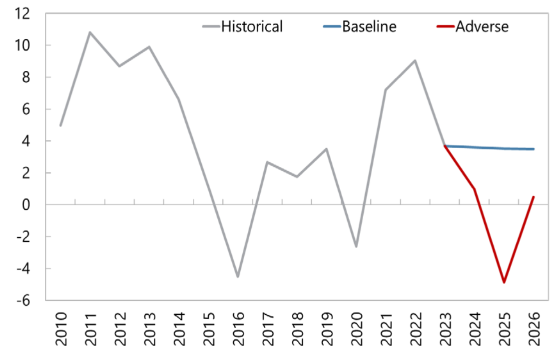
A global recession could trigger a plunge in oil prices…

Brent Oil Price
(USD/bbl)



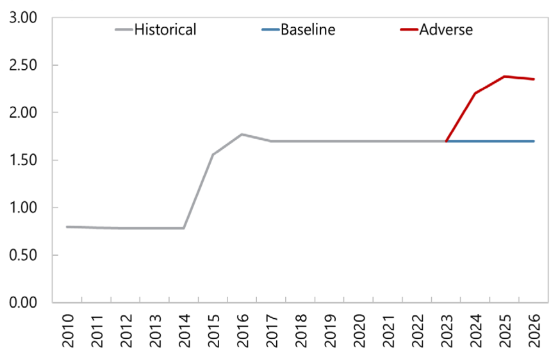
…causing a contraction in Azerbaijan's economy

Real Non-oil GDP Growth
(y/y percent change)



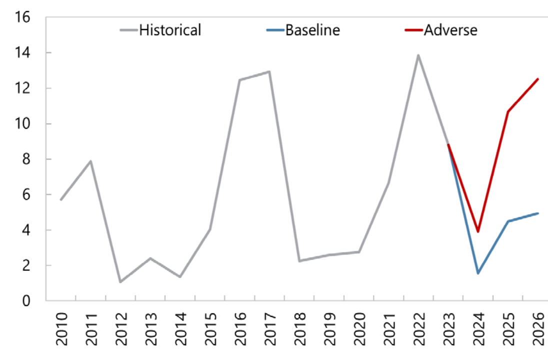
Manat would be devalued to restore external balance…

Nominal Exchange Rate
(end of period, USD/AZN)



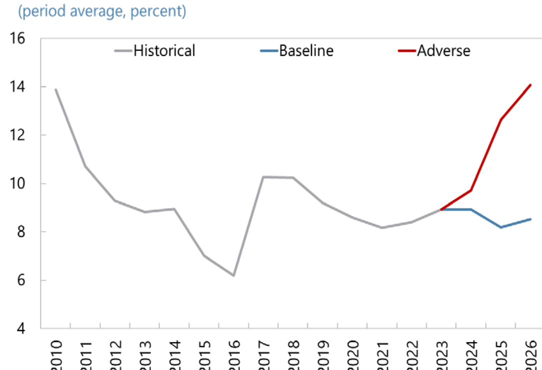
…reigniting inflationary pressure…

CPI Inflation
(period average, y/y percent change)



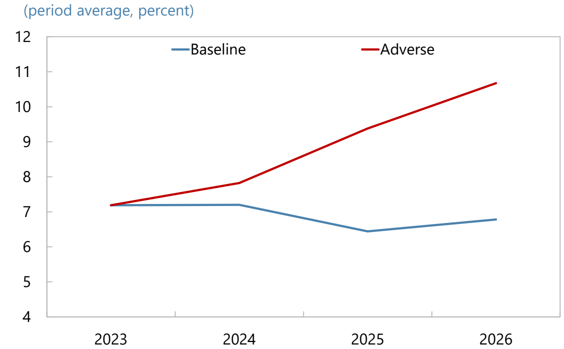
…prompting a tightening in domestic financial conditions

Average Interbank Rate
(period average, percent)



…and pushing long-term yields higher

4-Year Government Bond Yield
(period average, percent)



Note: A long historical time series is not available due to limited trading activity. The CBA has only been calculating and publishing data on yield curves since December 2023.

Sources: Central Bank of Azerbaijan, IMF World Economic Outlook, Haver Analytics, IMF staff calculations.

14. Under the adverse scenario, the capital ratios of the overall banking sector remained above the regulatory minima, but some banks—including D-SIBs—could face solvency pressures (Figure 9, Panels 2-6). Specifically:

- Eight banks (35 percent of total banking sector assets) breached one of the hurdle rates.[23] Of these, two are D-SIBs, while the remainder are mostly medium-sized banks. However, their collective capital shortfalls were contained at AZN657 million (0.5 percent of GDP), significantly lower than the bailout cost during the 2015-2016 crisis (23 percent of GDP). Since then, regulatory reforms, clean-up efforts, and closure of troubled banks have strengthened banks' risk management, underwriting practices, and asset quality.

- The systemwide total regulatory capital ratio declined by 4.5 percentage points to 13.7 percent by Year-2, primarily driven by a deterioration in credit quality.[24] The NPL ratio surged from 2.7 to 11.5 percent,[25] largely attributable to business loans, which constituted 55 percent of the overall credit portfolio.

- The impact of mark-to-market valuation was limited due to the small size of held-for-trading and available-for-sale portfolios relative to total assets.[26]

15. Banks that breached the hurdle rates under the adverse scenario initially had thin capital buffers and experienced rapid loan growth in the preceding years, leading to high leverage. Some of these banks had relatively high levels of undrawn guarantees and credit lines, which were assumed to be drawn down under the adverse scenario. These off-balance-sheet commitments—especially those that are irrevocable—could represent hidden risks.[27]

---

[23] Of which six banks—including one D-SIB—breached the leverage ratio hurdle rates. Systemwide leverage ratio decreased from 10.6 to 8.1 percent by Year-2, still above the minimum regulatory requirement.

[24] Another factor is FX valuation effects from a hypothetical manat devaluation.

[25] The peak of the projected NPL ratio under the adverse scenario (11.5 percent) is higher than the 2015-2023 average of 10.4 percent but lower than the end-2016 peak of 21 percent.

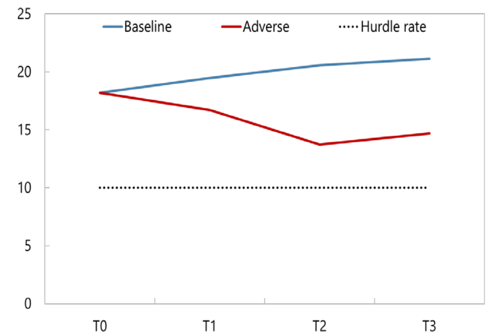
[26] Moreover, these portfolios had a relatively low duration of around 2 to 3 years on average. For the held-to-maturity (HtM) portfolio, a separate analysis suggested that the potential impact of additional funding costs from pledging HtM bonds during a liquidity stress event could be material for some banks. A hypothetical 30 percent deposit withdrawal could reduce the capital ratio of several banks by up to 2.5 percentage points.

[27] While credit lines provide support to borrowers, which in turn reduce banks' credit risk, large drawdowns could lead to a sudden increase in loans that decreases banks' capital ratios.

Figure 9. Azerbaijan: Bank Solvency Stress Test

The capital ratios of the overall banking sector remained above the regulatory minima

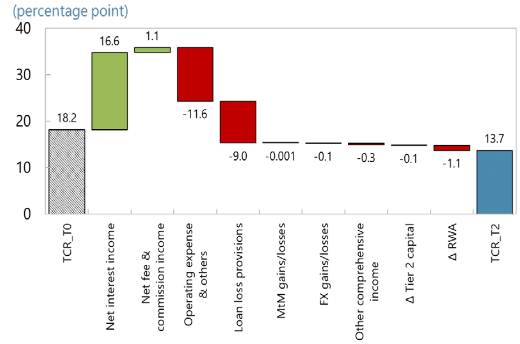
Total Regulatory Capital Ratio (TCR)
(percent)



Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

Under the adverse scenario, the decline in capital ratios was mainly driven by increased credit losses and RWA…

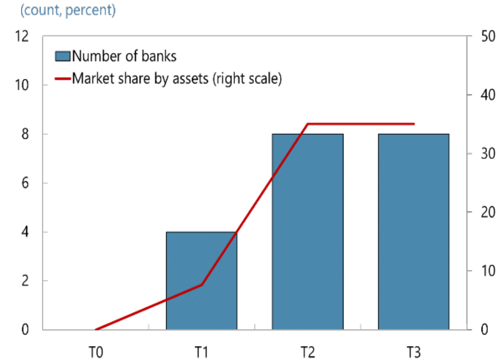
Adverse Scenario: Contribution to Cumulative Change in TCR from T0 to T2
(percentage point)



Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.
Note: Others include other non-interest income & expense, taxes, and dividends.

…with eight banks, including two D-SIBs, breaching the hurdle rates

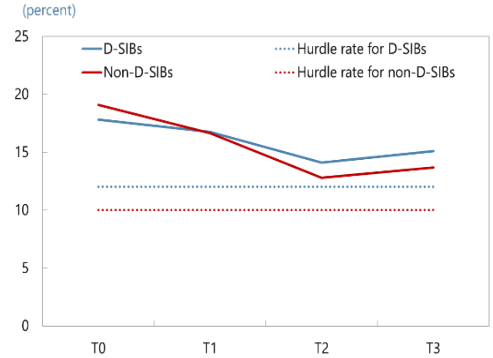
Adverse Scenario: Banks with Capital Shortfall
(count, percent)



Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

Non-D-SIBs experienced a larger decline in capital ratios compared to their D-SIB counterparts

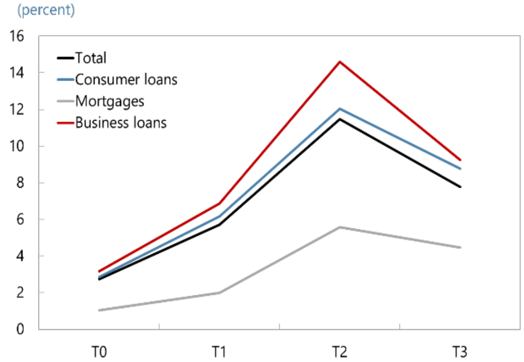
Adverse Scenario: Total Regulatory Capital Ratio
(percent)



Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

The overall NPL ratio surged more than fourfold, rising from 2.7 to 11.5 percent by Year-2…

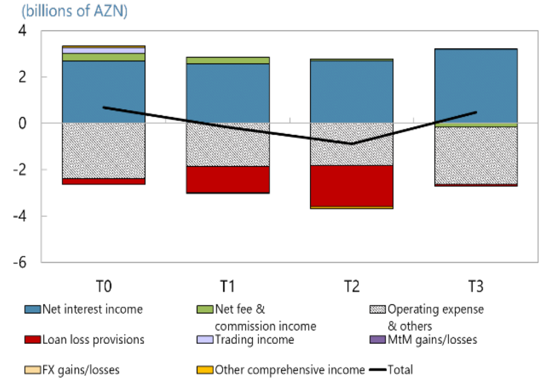
Adverse Scenario: NPL Ratio
(percent)



Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

…resulting in substantial loan loss provisions and the banking sector recording net losses in the first two years

Adverse Scenario: Total Comprehensive Income
(billions of AZN)



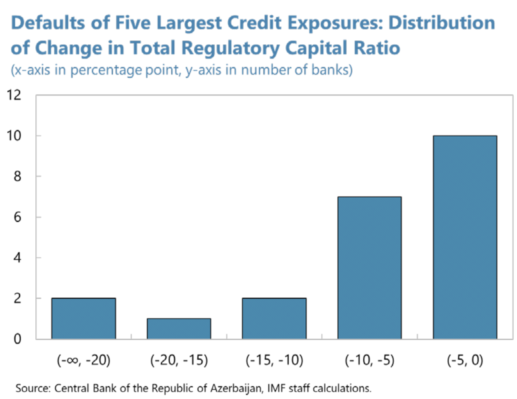
Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

16. Additional sensitivity analyses[28] indicate:

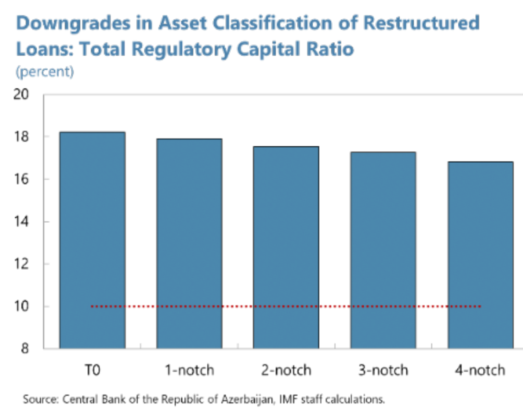
- ***Limited risks from restructured loans.*** The share of restructured loans has trended lower. In a worst-case scenario where all restructured loans default, the systemwide total regulatory capital ratio only declines moderately by 1.4 percentage points.
- ***High credit concentration risk.*** A hypothetical simultaneous default of each bank's five largest credit exposures could cause 10 banks to breach the hurdle rates. Many of these banks are heavily involved in corporate banking.

Azerbaijan: Sensitivity Analyses

The capital ratios of 12 banks would drop by more than 5 percentage points if their five largest exposures defaulted



Downgrading all restructured loans to the "loss" category would have a manageable impact on banks



Bank Liquidity Stress Test

17. The liquidity stress test was conducted over a horizon stretching up to12 months, encompassing three scenarios that reflect the potential release of required reserves (RR) during systemic liquidity stress.[29] It was complemented by a reverse liquidity test and an assessment of banks' deposit concentration risk. All analyses were conducted separately for manat and foreign currency.

Results:

18. Liquidity stress tests revealed that some banks have relatively low manat liquidity buffers, but the results were heavily dependent on the degree of RR release assumptions (Figure 10). Under stressed liquidity conditions persisting over a 12-month horizon, eight banks—including two D-SIBs—faced liquidity shortfalls, assuming RR were not released. Collectively, they accounted for 35 percent of total banking assets, with the shortfall amounting to AZN674 million

[28] Conducted separately from the solvency stress test.

[29] They include RR not released; half of RR released; and all RR fully released. According to the national regulation, RRs held at the CBA are not classified as liquid assets. During the 2015 crisis, RR was reduced to 0.5% from 2%.

(0.5 percent of GDP). Releasing half of the RR would significantly enhance banks' counterbalancing capacity (CBC), reducing the number of banks facing shortfalls to four. If RR were fully released, only two medium-sized banks would experience shortfalls totaling AZN74 million (0.06 percent of GDP).

19. Most banks maintained comfortable foreign currency liquidity buffers (Figure 11). Notably, market liquidity shocks had a limited impact as the bulk of the foreign currency CBC was in the form of cash and excess reserves at the CBA. Only three medium-sized banks (5 percent of total banking assets) had insufficient CBC assuming no release of RR. Their combined liquidity shortfall amounted to AZN69 million (only 0.06 percent of GDP). By releasing at least half of the RR, only two banks would face a shortfall.

20. Reverse liquidity tests indicated that the overall banking sector could withstand up to 48 and 64 percent of cumulative deposit outflows over a 12-month horizon for manat and foreign currency, respectively.[30] The assumed manat outflow rate is comparable to the largest historical peak-to-trough outflows observed during the manat devaluations in 2015. The foreign currency outflow rate is more than double during the 2016 economic recession.[31]

21. Sensitivity analysis highlighted significant deposit concentration in some banks, making them vulnerable to run risk. A simultaneous and sudden withdrawals of each bank's five largest deposits led to liquidity shortfalls in 10 banks, of which three are D-SIBs. Together, they accounted for 39 percent of total banking assets, and their liquidity shortfalls amounted to AZN2.1 billion (1.7 percent of GDP). For each of these banks, the five largest deposits constituted between 22 and 87 percent of their total customer deposits. Compared to others, some of these banks—including the three D-SIBs—showed a greater reliance on business deposits rather than individual deposits.

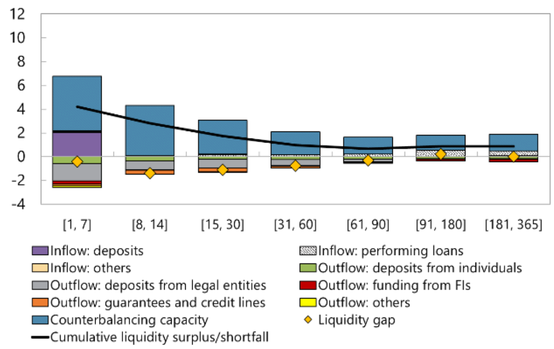
[30] Based on the assumption that RR were fully released. CBA uses RR as both monetary policy and prudential tool.

[31] Aggregate customer deposits in manat halved during the period from December 2014 to January 2016, while deposits in foreign currency declined by 24 percent from November 2015 to December 2016.

Figure 10. Azerbaijan: Manat Cash Flow-Based Analysis

Assuming RR were not released, the systemwide manat liquidity surplus was significantly reduced after one year…

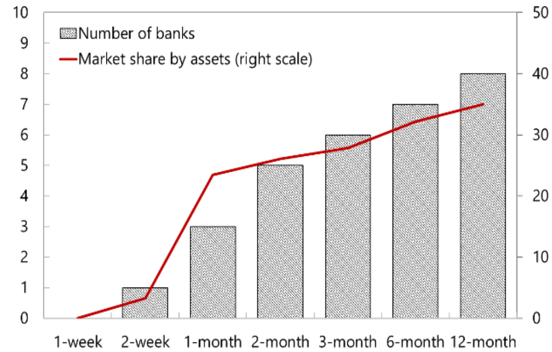
Manat Liquidity Surplus/Shortfall (RR Not Released)
(x-axis: time buckets in days, y-axis: billions of AZN)



Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

…with eight banks, including two D-SIBs, facing shortfalls totaling 0.5 percent of GDP

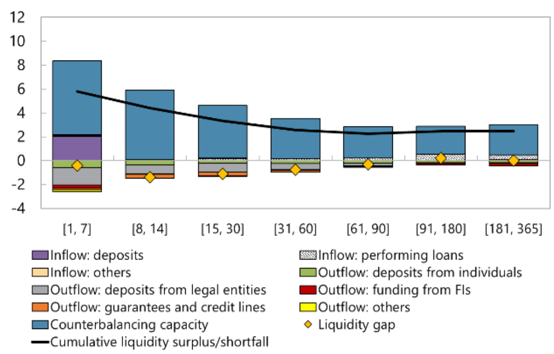
Banks with Manat Liquidity Shortfall (RR Not Released)
(x-axis: time horizons, y-axis: count, percent)



Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

Releasing half of RR would significantly enhance banks' counterbalancing capacity…

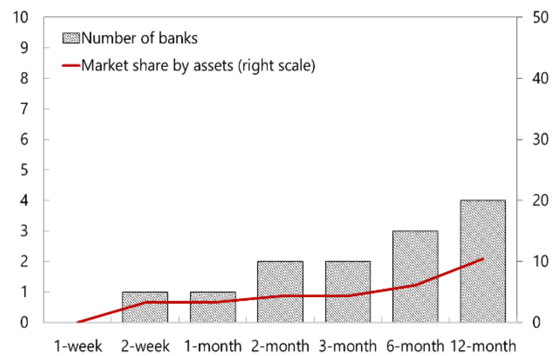
Manat Liquidity Surplus/Shortfall (RR Half Released)
(x-axis: time buckets in days, y-axis: billions of AZN)



Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

…reducing the number of banks experiencing shortfalls from eight to four

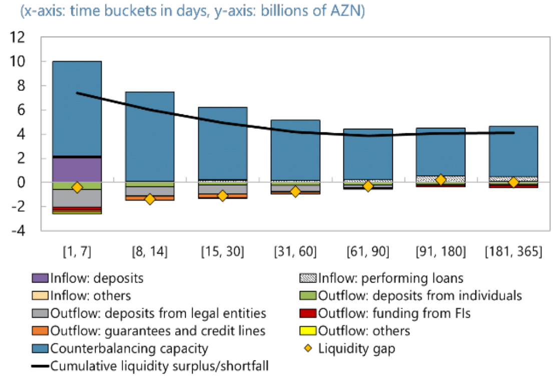
Banks with Manat Liquidity Shortfall (RR Half Released)
(x-axis: time horizons, y-axis: count, percent)



Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

If RR were fully released, the surplus would be substantially higher…

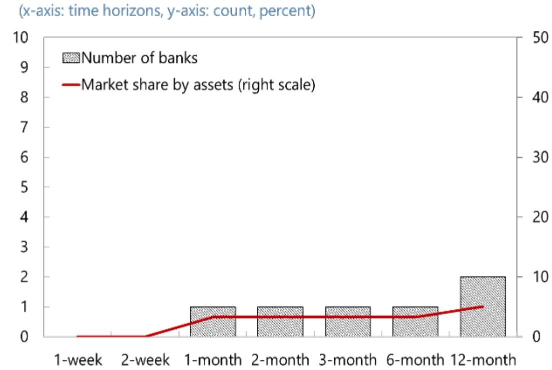
Manat Liquidity Surplus/Shortfall (RR Fully Released)
(x-axis: time buckets in days, y-axis: billions of AZN)



Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

…and only two banks would have insufficient counterbalancing capacity

Banks with Manat Liquidity Shortfall (RR Fully Released)
(x-axis: time horizons, y-axis: count, percent)



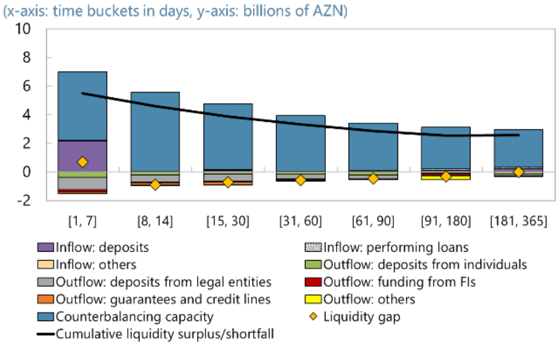
Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

Figure 11. Azerbaijan: Foreign Currency Cash Flow-Based Analysis

Even if RR were not released, the surplus in foreign currency liquidity remained sizable after one year…

Foreign Currency Liquidity Surplus/Shortfall (RR Not Released)

(x-axis: time buckets in days, y-axis: billions of AZN)

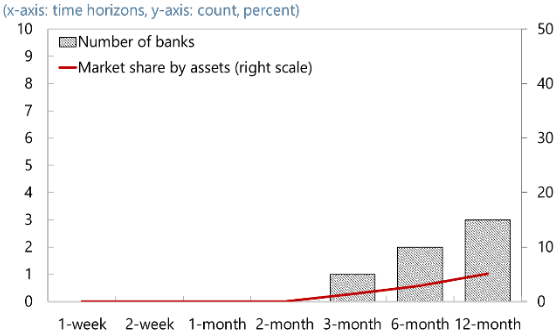


Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

…with only three medium-sized banks facing shortfalls totaling 0.06 percent of GDP

Banks with Foreign Currency Liquidity Shortfall (RR Not Released)

(x-axis: time horizons, y-axis: count, percent)

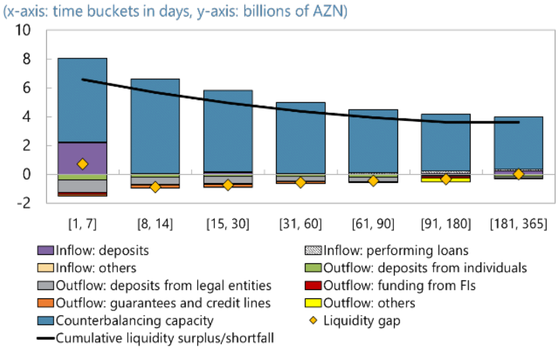


Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

Assuming half of RR were released…

Foreign Currency Liquidity Surplus/Shortfall (RR Half Released)

(x-axis: time buckets in days, y-axis: billions of AZN)

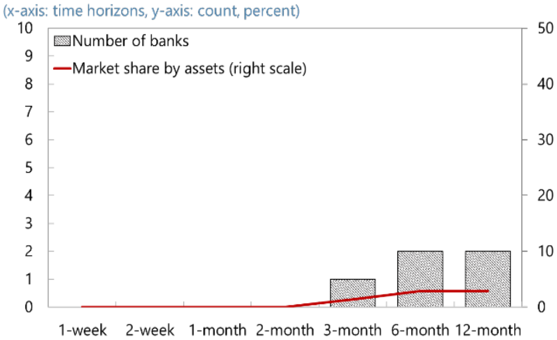


Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

…one fewer bank would experience a shortfall

Banks with Foreign Currency Liquidity Shortfall (RR Half Released)

(x-axis: time horizons, y-axis: count, percent)

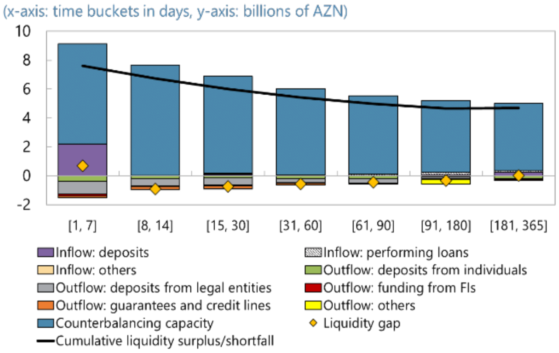


Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

If RR were fully released…

Foreign Currency Liquidity Surplus/Shortfall (RR Fully Released)

(x-axis: time buckets in days, y-axis: billions of AZN)

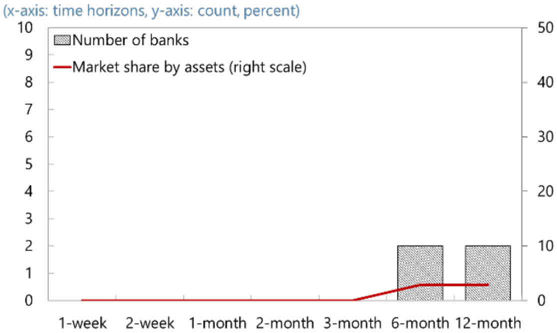


Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

…all banks would have surpluses over a three-month horizon

Banks with Foreign Currency Liquidity Shortfall (RR Fully Released)

(x-axis: time horizons, y-axis: count, percent)



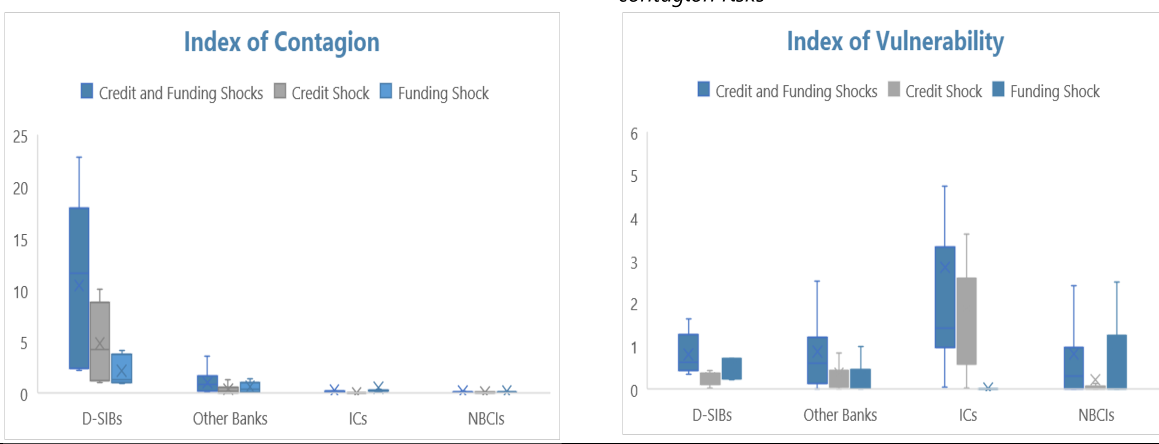
Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.

C. Contagion Analysis

22. Contagion risks arising from direct exposures among domestic financial institutions are significant (Figure 12). D-SIBs pose substantial contagion risks, as expected. The distress of a D-SIB, on average, could reduce the amount of regulatory capital of affected FIs—other banks, insurance companies, and NBCIs—by 10.4 percent and result in the distress of 11 of them. Insurance companies—especially those with low solvency ratios and large deposit placements in banks—are most vulnerable to contagion risks. Almost half of insurance companies had deposits in banks exceeding the amount of their regulatory capital, with some of these deposits concentrated in a few D-SIBs. Notably, interlinkages between NBCIs and banks—particularly D-SIBs—have grown over the past decade, with exposures representing a significant share of NBCIs' capital.[32] These interlinkages have made NBCIs vulnerable to the distress of D-SIBs.

Figure 12. Azerbaijan: Interconnectedness and Contagion Analysis

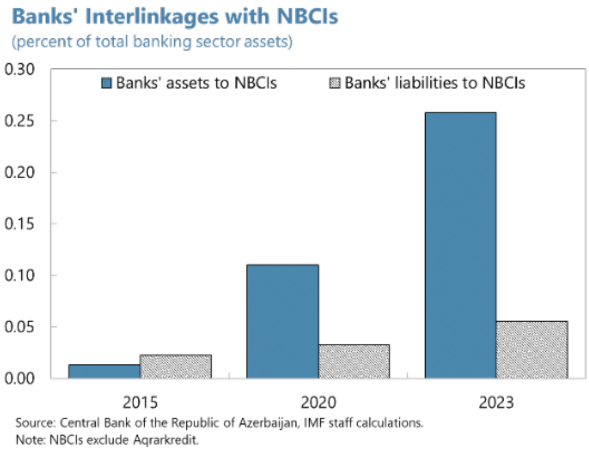
Analysis shows that spillover from the distress of D-SIBs is the most severe… *…while insurance companies (ICs) are most vulnerable to contagion risks*



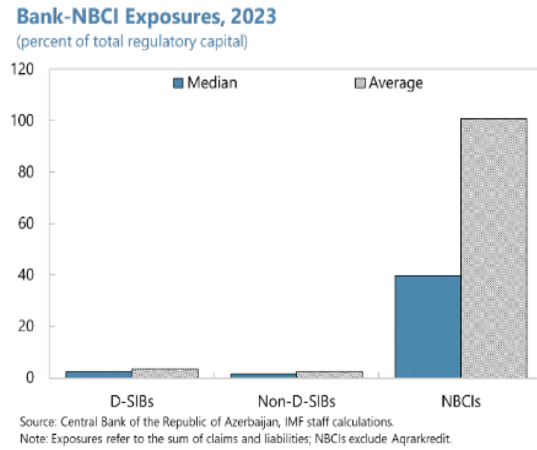
[32] While these exposures—sum of claims and liabilities—amounted to a median of 40 percent and up to five times the capital of individual NBCIs, they represented only 0.8 to 7.2 percent of the D-SIBs' respective capital.

Figure 12. Azerbaijan: Interconnectedness and Contagion Analysis (concluded)

Interlinkages between NBCIs and banks have grown…



…with exposures representing a significant share of NBCIs' capital



Sources: Authority data and IMF staff computations

Notes:
(i) The two boxplots at the top are drawn from first quartile to third quartile; the horizontal line inside indicates median. The cross mark denotes average, while the whiskers extending from the box represent the range of the data, excluding outliers.
(ii) Total exposures refer to the sum of asset-side and liability-side exposures.
(iii) Index of contagion: Average percentage of loss in other institutions due to the distress of a given institution.
(iv) Index of vulnerability: Average percentage of loss in a given institution due to the distress of all other institutions.
(v) The hurdle rates were set at the minimum total regulatory capital ratio requirement of 12 percent for D-SIBs, 10 percent for other banks, and 100 percent for insurance companies and NBCIs.

D. Corporate Vulnerability Analysis

23. **The financial health of nonfinancial corporations has improved since the 2015-16 economic downturn, but vulnerability to global risks remains.** While corporate profitability has recovered and doubled during the 2020-23 period, leverage is on the rise as aggregate debt-to-equity in the non-oil and gas sector increased from 85.6 percent in 2020 to 96.8 percent in 2022, although it tapered slightly in 2023. Similar to most other emerging economies, external headwinds from global economic weaknesses could put pressures on firm's earnings. Additionally, exchange rate risk remains relevant as foreign currency debt comprised 42 percent of total corporate debt in 2023. A market risk sensitivity analysis conducted on the 50 largest firms—combining earnings, interest rate, and exchange rate shocks—suggests that a hypothetical currency depreciation is the most severe shock, reinforcing the importance of FX hedging (Figure 13).[33] Under the most severe

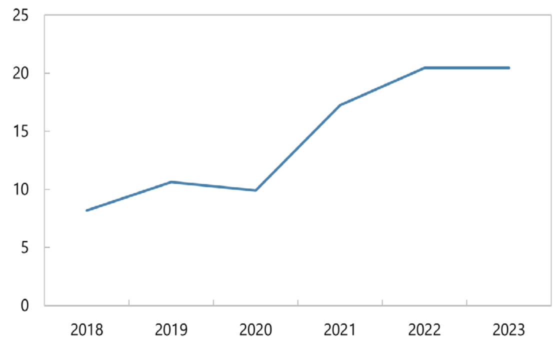
[33] About 60 percent of firms' FX risks are hedged, on average, as of March 2024.

scenario (assuming no FX hedging), defaults could lead to an increase in banks' NPLs to levels seen during the 2016 economic downturn and some banks may experience capital shortfalls.[34]

Figure 13. Azerbaijan: Nonfinancial Corporate Balance Sheet Analysis[1]

Corporate profitability recovered post-pandemic but is tapering …

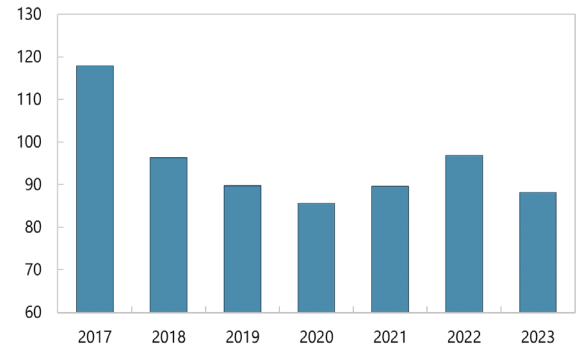
Nonfinancial Corporate Return on Equity
(Percent)



Sources: State Statistical Committee of the Republic of Azerbaijan, IMF staff calculations.
Note: Excludes oil and gas sector.

… and leverage is increasing

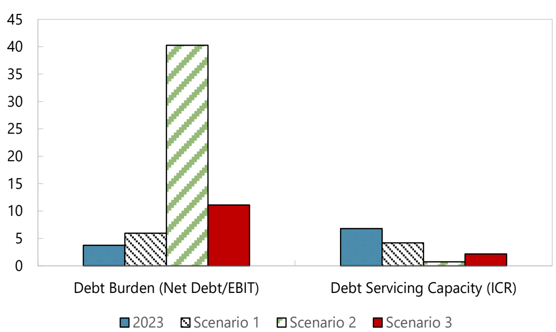
Nonfinancial Corporate Debt-to-equity Ratio
(Percent)



Sources: State Statistical Committee of the Republic of Azerbaijan, IMF staff calculations.
Note: Excludes oil and gas sector.

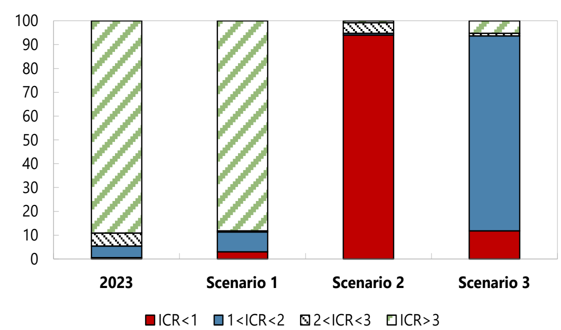
A combination of earnings, interest expense, and exchange rate shocks significantly increases firm's debt burden and reduce their debt servicing capacity

Median Debt Burden and Debt Servicing Capacity (Ratios)



… triggering a sharp increase in debt-at-risk (i.e., corporate debt with ICR< 1) in a hypothetical Scenario 2 where the currency depreciates and is not hedged

Corporate Debt Profile
(In Percent Total Debt)

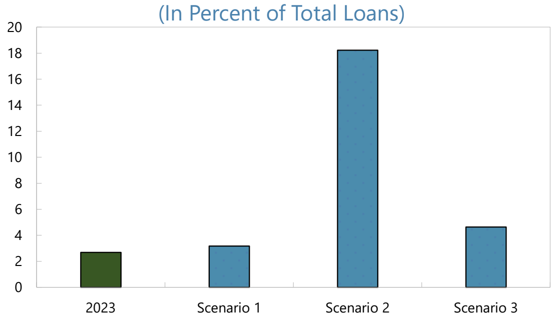


[34] A hypothetical 30 percent depreciation in manat—along with 20 percent decline in corporate earnings and 30 percent increase in borrowing costs (based on shocks witnessed during the GFC)—could reduce firms' median interest coverage ratio (ICR) below 1, prompting difficulties in servicing debts and potentially increasing the banking sector's gross NPL ratio to 18 percent.

Figure 13. Azerbaijan: Nonfinancial Corporate Balance Sheet Analysis (concluded)

Shocks in Scenario 2 (most severe) could lead to an increase in banks' NPL to levels seen during the 2016 downturn…

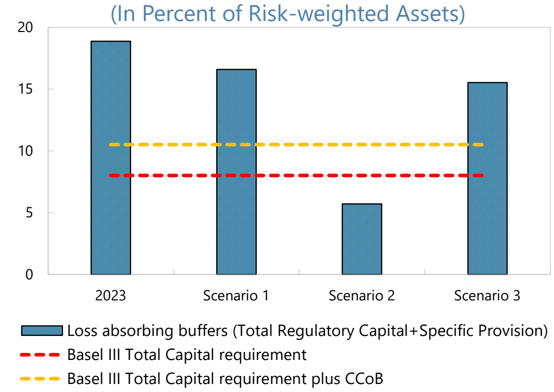
Gross Nonperforming Loan Ratio
(In Percent of Total Loans)



Notes:
(i) Assumes 6.6% of the corporate debt-at-risk in each scenario will default, based on S&P average annual default rate for EMs (2.98%) plus one standard deviation (3.59%) over the 1981 to 2023 period).
(ii) These results are in line with the solvency stress test on business loan portfolio, which shows that the NPL ratio in this sector could increase to 14.6% under the adverse scenario.

… bringing banks' loss-absorbing buffers below the minimum Basel III capital requirements in the most severe scenario

Banks' Loss Absorbing Buffers
(In Percent of Risk-weighted Assets)



Notes:
(i) Scenario 1: Assumes 20% decline in earnings and 30% increase in borrowing costs;
(ii) Scenario 2 (most severe): Assumes shocks similar to Scenario 1 and a 30% hypothetical exchange rate depreciation;
(iii) Scenario 3: Assumes shocks similar to Scenario 2, but with 60% currency hedging.

Source: Central Bank of Azerbaijan, IMF staff computations

1/ Based on a sample of 50 large corporations. Debt-at-risk refers to total debt of firms with interest coverage ratios below 1.

FINANCIAL SECTOR OVERSIGHT

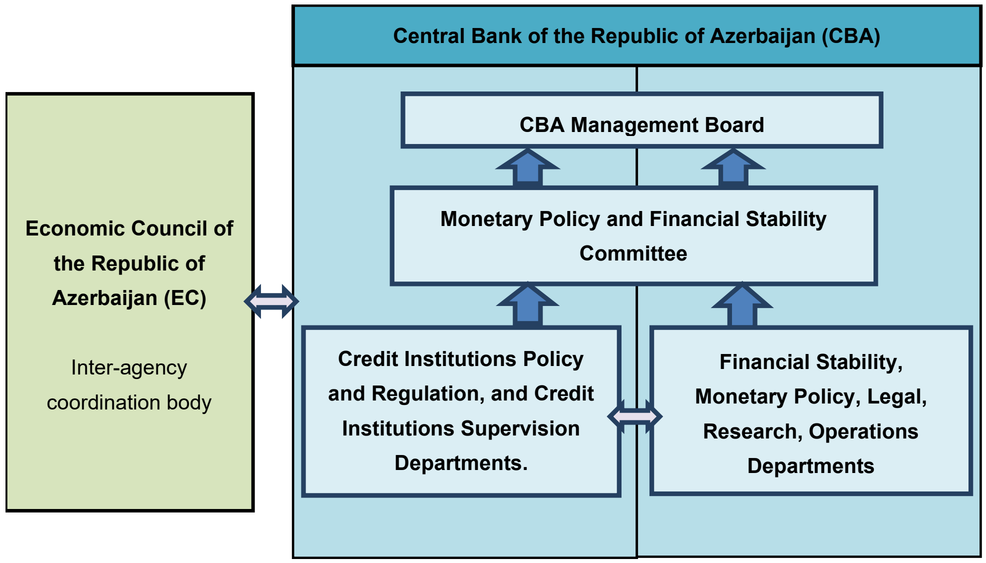
24. **The CBA is responsible for financial sector oversight, including macroprudential policies for the banking sector.** In 2019, the CBA replaced the Financial Market Supervisory Authority of Azerbaijan (FIMSA) as the primary regulator of the financial sector. The 2022 amendments to the Law on Central Bank of Azerbaijan (LCBA) gave CBA the financial stability mandate and power for financial market and macroprudential oversight. Since then, commendable progress has been achieved in implementing the 2015 FSAP recommendations, including some headway in addressing the 2022 World Bank development module FSAP recommendations (Table 7 and Table 8).

A. Systemic Risk Oversight and Macroprudential Framework

25. **Azerbaijan's institutional framework for macroprudential policy broadly meets the principles of good design and could be enhanced by publishing a macroprudential strategy**. The current framework places all macroprudential powers within the CBA, underpinned by the LCBA that provides the mandate and ability to act. Multiple measures taken in recent years have shown that the authorities have both the willingness and ability to act. Disseminating a macroprudential policy strategy with clear objectives and key indicators will help to guide the timing to activate

macroprudential policy tools, communicate to the public, and bolster transparency and accountability.[35]

Azerbaijan: Decision-Making Process of Macroprudential Policy



Sources: IMF iMaPP.
Note: This figure shows the lines of decisions and collaborations among key players in the decision-making process for macroprudential policy.

26. Important progress has been achieved in developing the macroprudential policy toolkit to enhance banks' resilience, including FX risks from high dollarization. Since the 2015 FSAP, the CBA has established a comprehensive macroprudential policy toolkit, covering borrower-based measures,[36] capital buffers that include CCyB and additional capital requirement for D-SIBs, restrictions on large exposures and limits on open FX positions, higher reserve requirements for FX deposits, and liquidity measures that include LCR implementation in 2023 in line with Basel III. A 0.5 percent CCyB is imposed on banks starting March 1, 2025.

27. Further improving the systemic risk monitoring framework and expanding the macroprudential policy toolkit will help enhance banks' resilience. Specifically:

- ***Addressing data gaps:*** The CBA already collects a range of indicators; regularly monitors and analyzes systemic vulnerabilities and undertakes stress tests; identifies systematically important institutions; and publishes the Financial Stability Report (FSR). Strengthening forward-looking monitoring—through an early warning system—would require addressing the remaining data

[35] It should outline intermediate objectives, describe policy tools and principles for their deployment, map risks to the tools, and offer communication guidelines.

[36] Include limits on loan-to-value ratios for consumer and real estate loans, and cap on debt-to-income ratios for consumer loans. FX-related measures include restrictions on FX mortgages and higher risk weights on FX-denominated consumer loans and FX loans to unhedged corporate borrowers.

gaps in households and nonfinancial corporate sector. Additionally, developing analytical capacity to assess climate change-related risks will help enhance its systemic risk dashboard.

- ***Strengthening communication:*** The CBA could utilize its FSR to explain policy decisions, including the rationale behind macroprudential policy decisions and their effects.

- ***Expanding the policy toolkit:*** Extending capital buffer requirements—such as capital conservation buffer, positive neutral CCyB,[37] and differentiated higher loss absorbency buffer requirements for D-SIBs—would further reinforce loss-absorbing capacity, supported by the current strong capital position in the banking sector.[38] Implementing the Net Stable Funding Ratio—in addition to LCR—would mitigate funding risks over a longer time horizon. Additionally, establishing sectoral buffers will alleviate risks confined in certain sectors (e.g., consumer lending) or exposures to specific borrowers (e.g., FX and concentration risks).

28. Sound macroeconomic policies are the main precondition for continued successful de-dollarization.[39] Widening the relatively narrow wedge between required reserves on manat and FX deposits would reduce banks' incentives to raise FX deposits. More granular data on borrowers' unhedged exposures to exchange rate risk would allow better monitoring, while continued steps to develop the domestic capital markets—including regularly issuing benchmark local currency bonds—would support further de-dollarization.

B. Banking Supervision and Regulation

29. The CBA made commendable efforts to implement the BCBS' international standards adjusted for the domestic setting, strengthening prudential requirements, corporate governance, and risk management standards. Many of these improvements are at an early stage. In line with the FSDS, the CBA is implementing Basel III prudential standards. A new RBS model has been developed based on international best practices, with the first pilot commencing in early-2025.

30. A larger share of banks is fully compliant with prudential requirements now, following enhanced supervisory actions. The 2015 FSAP identified a considerable number of banks breaching multiple prudential requirements (10 banks), especially the related-party exposure limits.

[37] Positive cycle-neutral CCyB aims to provide buffer for the banking sector in stress periods that are not preceded by excess credit growth.

[38] As the existing minimum regulatory capital requirement is 12 percent/(10 percent) for D-SIBs/(all other banks), introducing additional buffers will not require significant increase in capital.

[39] While dollarization is not a vulnerability per se, its associated risks—e.g., FX mismatch and currency-induced credit risk—may be systemic. Therefore, macroprudential tools are primarily used to bolster resilience against these systemic risks rather than reducing dollarization directly.

The number of banks breaching this limit declined from 4 at end-2018 to 1 in March 2024,[40] while two banks did not comply with the limit on large exposures. Closer monitoring of corrective actions' implementation and revoking the licenses of six insolvent banks in past years contributed to this improvement. Enhancing enforcement—including sanctioning and other prudential requirements—in cases of material shortcomings in related-party transactions will improve compliance.

Azerbaijan: Large and Related Party's Exposures (2018–2024)

Number of banks	December 2018		March 2024	
	Large Exposure	Exposures to Related Parties	Large Exposure	Exposures to Related Parties
Compliant	23	26	21	22
Non-compliant	7	4	2	1
Total	**30**	**30**	**23**	**23**

Source: Central Bank of Azerbaijan

31. The lack of a consolidated supervision continues to hinder proper control of related-party transactions and other prudential aspects. Without an effective consolidated supervision, transactions with some group companies may not be fully captured as related-party exposures. Consolidated supervision is critical for two D-SIBs that are part of a banking group with subsidiaries, affiliated financial entities, and holding company. As part of the FSDS, the CBA has been working on implementing a consolidated supervision framework to reinforce the understanding and control of intra-group risks of D-SIBs and other banks, as well as setting prudential requirements (e.g., capital adequacy, liquidity, exposure limits) on a consolidated basis.[41]

32. Further improvements would reinforce the effectiveness of CBA's supervisory authority. Specifically:

- ***CBA's governance, independence, resourcing, and supervisory approach.*** Strengthening the LCBA—supported by IMF technical assistance—and enhancing supervisory approach will reinforce the CBA's oversight (Appendix II).

- ***Disclosure and transparency.*** Although the "Corporate Governance Standards" require banks to disclose information in line with Basel's Pillar 3 requirements, some disclosure practices deviate from the Basel standards. For example, banks' disclosure of ownership varies—some

[40] This particular bank had total exposures to related parties amounting to 26 percent of total regulatory capital (regulatory limit set at 20 percent). The loan is guaranteed by the borrower's own deposits, in line with the regulatory requirement (collaterals). The breach was deemed reversed in September 2024 following a new regulation that allowed the loan to be netted off against the borrower's deposit collateral.

[41] The strategic initiative "Adoption of risk-based and consolidated regulation and supervision framework" has the following main sub-activities: (i) identification of the most suitable RBS model; (ii) testing the model and instruments on selected pilot banks; (iii) modernizing supervision processes in accordance with the selected RBS model; and (iv) identifying the most suitable approach to consolidated supervision.

disclose only direct shareholders while others include beneficial owners (BOs).[42] For related-party transactions, CBA's regulation only requires disclosing "general information on operations with related parties (size, number, etc.)" while the scope and structure of information for disclosure is not defined.[43] As this information is relevant for evaluating fit and proper, solvency and regulatory compliance, and promoting market discipline, improving the disclosure requirements will level the playing field across all banks.

- ***Prudential treatment of certain types of loans.*** Same risk weights are applied to performing and nonperforming mortgages.[44] This departs from the Basel standard, which applies a higher risk weight of 100 percent to defaulted mortgage exposures after netting off specific provisions, with a supervisory discretion to reduce that risk weight to 50 percent. Likewise, certain agricultural loans[45] are exempted from the requirements to set aside around 10 percent of additional provisions applied for business loans. Although regulations are generally stricter for agricultural loans in other aspects (e.g., underwriting and restructuring), prudential requirements should prevent the perception of pursuing development objectives at the cost of financial stability. Moreover, closing the regulatory gap will ensure that capital and provisions requirements are consistent with international standards and inherent risks.

33. Differences in financial and prudential reporting standards affect required loan-loss provisions, the latter being more conservative. Banks follow IFRS for financial reporting purposes (e.g., audited annual financial statements) but adhere to the regulatory standardized approach for prudential reporting and asset classification and provisioning. The regulatory approach gives higher prudential loan-loss provisioning than IFRS 9 for consumer loans following stricter provisioning requirement on borrowers with DTI ratio above 45 percent.[46] The CBA is evaluating the feasibility of making adjustments, including applying the highest loan-loss provision from both approaches.

C. Financial Integrity

34. Azerbaijan has considerably strengthened its AML/CFT legal and institutional framework. Corruption, tax evasion, drug trafficking, and smuggling were identified as the main

[42] Based on private D-SIBs' websites, two D-SIBs disclosed their BO-related information and another two D-SIBs disclosed the first level of ownership.

[43] CBA can consider expanding a standardized template, whereby at least segmented information can be presented by collateralization, type of relationship, size of the loan (as a percentage of regulatory capital)—among other criteria—that help foster discipline in the management and control of these operations in banks.

[44] Mortgages accounted for 16 percent of banks' loan portfolio as of December 2023. The MCGF-funded mortgages amounted to 56 percent of banks' mortgage loans; they combine cheap term-funding with a low interest rate cap on long-term mortgages. MCGF-funded mortgages are assigned a lower risk weight of 35 percent (or 0 percent if they have a public guarantee) compared to 50 percent for those funded by banks' own funds. Only 3 percent of MCGF-funded mortgages are guaranteed by the MCGF, and they are recognized in the general government debt.

[45] Business loan granted to micro, small and medium business entities and family farms operating in the agricultural sector (in manat) for the purpose of financing of agricultural production costs, trade and processing of agricultural products, as well as projects for the development of the agricultural sector.

[46] As of December 2022, CBA reported that the total loan-loss provision for prudential purposes exceeded IFRS 9 provision by around 80 percent for the top 10 banks.

proceeds-generating offences.[47] The authorities made notable progress on AML/CFT legal and institutional reforms, including requiring compliance by financial institutions. Remaining gaps related to financial sector risk-based AML/CFT supervision, wire transfers, and transparency of legal entities should be swiftly addressed. Notably, the authorities should introduce measures to ensure multiple sources of beneficial ownership information.

35. Effective implementation of the updated AML/CFT framework remains a priority. MONEYVAL's 2023 AML/CFT assessment report found a low level of effectiveness on AML/CFT financial sector supervision; and moderate effectiveness on implementation of preventive measures by this sector and on transparency of beneficial ownership of legal entities.[48] Improving effectiveness in these areas is crucial to strengthen financial sector resilience to ML/TF risks. Therefore, the authorities should prioritize implementing a system for risk-based AML/CFT supervision of banks; strengthen supervisory resources and enforcement efforts; and address gaps in implementing fit and proper measures in bank ownership, particularly in verifying their beneficial owners and conducting requisite checks. Supervisory efforts should also be directed towards bolstering preventive measures related to politically-exposed persons and beneficial owners; improving transaction monitoring; and suspicious transaction reporting.

SYSTEMIC LIQUIDITY, FINANCIAL CRISIS MANAGEMENT AND RESOLUTION

A. Systemic Liquidity Management

36. Since the 2015 FSAP, the CBA has made significant strides in systemic liquidity management, including modernizing its operational framework. Commendable advancements include introducing refinancing facilities, implementing Basel III LCR, and developing benchmark interest rates for secured and unsecured transactions with the Baku Stock Exchange. Despite high deposit dollarization, FX liquidity risks are well managed with sufficient FX liquidity provision in coordination with SOFAZ.

37. Further improvements in the government bond market, interbank repo, and collateral framework will enhance market depth. Bureaucratic settlement procedures delay executing transactions and impede timely settlements. The repo market—while much smaller in size than the unsecured interbank market—has the potential to grow and serve as an additional shock absorber for liquidity risk. To support fair valuation of collaterals, CBA should develop a database of daily indicative market prices for government securities. Introducing haircuts that rise with residual

[47] Embezzled state funds and other illicit proceeds are often laundered through the banking sector and misuse of legal entities.

[48] Azerbaijan was also rated as having a moderate level of effectiveness on risk, policy and coordination, the financial intelligence function, ML-related investigations, prosecutions and confiscation, and implementation of targeted financial sanctions for terrorism and proliferation financing.

maturity will enhance CBA's existing collateral framework, which also play a catalytic role in repo market development and help manage credit risks.

38. Moving the return and repayment of the funds deposited/borrowed in the central bank standing facilities to the beginning of the day will incentivize banks to produce better liquidity forecasts and rely more on interbank markets. In some countries, funds borrowed and deposited at the central bank facilities are returned or repaid before the start of the trading session.

B. Financial Safety Net and Crisis Management

39. Since the 2015 FSAP, the authorities have updated the legal, policy, and procedural framework for bank resolution and taken measures to enhance the LoLR function. The CBA has established a separate Resolution Department with wide responsibilities, ranging from recovery planning to organizing/managing resolution measures, and supervising liquidators. Amendments to relevant laws[49] introduced additional resolution powers, established conditions for the deposit insurance fund to borrow from the CBA with government guarantee, and prevented the CBA from providing subordinated loans to insolvent banks (Appendix III). Additionally, the CBA issued regulations to overhaul bank resolution. Further enhancements to reinforce the effectiveness of financial safety net include:

- ***Institutional and interagency arrangements:*** The authorities should strengthen the cooperation and coordination across financial safety net agencies—including foreign supervisory authorities—through MOUs. Establishing an interagency committee (e.g., Financial Stability Committee) comprising the CBA, MOF and ADIF would enhance collaboration on crisis preparedness and management, with each safeguarding its own responsibility and autonomy. Given the CBA's dominant role in ensuring financial stability, it should be charged with coordinating the FSC activities with the Governor chairing the committee. The committee's role on bank resolution should be formalized as coordination, without preempting the powers and initiative of the CBA as resolution authority.

- ***Early intervention triggers:*** Establishing forward-looking early intervention triggers would enable intervention in a timely manner in response to deteriorating financial conditions and initiate corrective actions well before the breach of any regulatory requirement. These early warning indicators could be incorporated as tools to escalate supervision in response to the gradual build-up of stress.

- ***Resolution framework:*** The resolution framework should be extended to include bank holding companies/conglomerates and significant non-regulated operational entities within the group. The CBA should be empowered to use its resolution powers without a requirement for court approval. It should prepare resolution plans for D-SIBs and other banks whose failure would have systemic consequences, and asses their resolvability. Resolution planning and resolvability

[49] Law on Banks, Law on Deposit Insurance, and Central Bank Act.

assessment should be updated regularly as material changes in a bank or economic conditions arise.

- ***Emergency Liquidity Assistance:*** In line with 2015 FSAP recommendations, the CBA is no longer authorized to provide subordinated loans to banks with capital adequacy problems. Instead, it can provide ELA to banks with short term liquidity shortages up to six months maturity, extendable once for another six-month period. The provision of ELA should be as a last resort after the exhaustion of alternative funding resources and conform to strict conditionality, including short maturity (e.g., two weeks) with extensions based on reassessments. It should be at a sufficiently high interest rate and reasonable premium over the Standing Lending Facility rate, against eligible and adequate collateral, and only to solvent and viable banks with temporary liquidity shortages. There should be adequate safeguards to protect the CBA's balance sheet, with government indemnity. A comprehensive framework should be established, incorporating eligibility criteria; ELA terms and conditions; robust collateralization and valuation strategy; policies for collateral valuation; ELA master agreement and funding templates; governance requirements; reporting requirements; termination provisions; modalities for national coordination and cross-border cooperation; and CBA's contingency planning, communication and exit strategies.

40. The CBA's Supervisory Review Process and early intervention framework should integrate bank recovery plans. As part of the Financial Sector Modernization Project supported by the World Bank, the CBA drafted a "Methodological Guidance for Banks' Recovery Plans" and planned to integrate it into the RBS framework. The CBA should provide guidance on the assessment of critical functions and shared critical services; integration of banks' recovery plans with their risk management framework; recovery options; and a robust communication strategy to ensure that internal and external stakeholders are suitably informed during recovery. Additionally, it should eventually require the preparation of recovery plans at bank holding company/conglomerate level to address the recovery of financial subsidiaries that are not subsidiaries of a bank but whose financial deterioration would adversely affect the bank.

41. Temporary public funding should be subject to strict conditionality to minimize the risk of moral hazard. It should be provided only when necessary to safeguard financial stability and enable implementing the most orderly resolution option to prevent any costly alternatives (Box 1). Private resources should first be exhausted. Thereafter, public funds should only be used after the allocation of all estimated losses in the failed bank to shareholders and—to the extent possible—unsecured creditors. There should be pre-defined mechanisms for loss recovery, such as ex-post levies from the banking sector. Under strict conditionality, temporary public funding could be extended to non-systemically important banks whose failure could derail financial stability.

AUTHORITIES' VIEWS

42. The authorities welcomed the FSAP's comprehensive assessment of Azerbaijan's financial sector, including commendable progress in financial policy frameworks. They concurred that the shift in financial sector regulation back to the central bank in 2019 has helped reinvigorate the regulatory reform agenda and underpinned resilience, especially during the COVID-19-driven global economic downturn in 2020. They noted that high dependency on oil and gas sector and substantial wholesale corporate deposits continue to be the main sources of vulnerabilities in the banking sector. They highlighted that numerous policy measures have been taken to moderate the recent rapid growth in unsecured consumer lending and would consider Pillar 2 supervisory approach to address bank-specific risks. They found the engagement with the FSAP useful in bringing additional perspectives to their risk analysis, and financial sector policy and regulatory frameworks.

43. The authorities broadly agreed with the conclusions of the systemic risk analysis. They concurred that while the overall banking sector would remain adequately capitalized and liquid under adverse conditions, some banks could face pressures and may need to reinforce their capital and liquidity buffers. They are committed to addressing data gaps, expanding their systemic risk analysis and stress testing frameworks to capture a wider spectrum of vulnerabilities across a broader range of financial players, and effectively utilizing their toolkits by integrating the findings into preemptive policy and supervisory actions. They noted that the high level of dollarization is attributed to dollar deposits held mostly for investment purposes by large corporations in the hydrocarbon sector and a small group of individuals.

44. The authorities noted that the implementation of the FSAP's recommendations on macroprudential policies and banking regulation-supervision is already ongoing. They appreciated the recognition of important progress made in recent years. In line with the FSDS, they welcomed the recommendations on adopting Basel III capital and liquidity requirements, and implementing RBS and consolidated supervision. They have published a macroprudential policy framework and implemented a CCyB requirement of 0.5 percent of total regulatory capital and Tier 1 capital starting March 1, 2025. While expressing interest in positive cycle-neutral CCyB, they noted that its activation should be aligned with prevailing macroeconomic and financial conditions. In principle, they concurred with the recommendation to widen the wedge between required reserves on manat and FX deposits, but noted that further analysis is needed first to determine the level of natural dollarization.

45. The authorities agreed with the recommendations to strengthen regulatory-supervisory oversight and will prioritize based on resource constraints. Recommendations that would be prioritized include enhancing the CBA's institutional framework, developing the RBS framework, and expediting consolidated supervision. Regarding AML/CFT, they emphasized that Azerbaijan has an existing 2023–25 National Action Plan. Additionally, short-term plans have been developed to address deficiencies identified in MONEYVAL's assessment. The National Action Plan includes proposals for establishing a database on beneficial owners.

46. **The authorities broadly concurred with the recommendations on strengthening financial safety nets and systemic liquidity.** They agreed to further enhance the crisis management and resolution frameworks, noting that the resolution plan design should consider country circumstances and current coverage of the resolution framework. They look forward to a follow-up technical assistance covering legal aspects to incorporate bank holding companies and significant non-regulated operational affiliated entities within the resolution framework. They also agreed with the need to foster the development of the government bond market to enhance market's ability to withstand liquidity shocks.

Table 2. Azerbaijan: Selected Economic Indicators, 2022–30

			Est.	Projections					
	2022	2023	2024	2025	2026	2027	2028	2029	2030
	(Annual percentage change, unless otherwise specified)								
National Income									
GDP at constant prices	4.7	1.4	4.1	3.5	2.5	2.4	2.4	2.5	2.5
Of which: Oil sector 1/	-2.4	-2.0	0.3	0.2	-0.5	-0.5	-0.5	-0.5	-0.5
Non-oil sector	9.1	4.5	6.2	4.5	3.7	3.5	3.5	3.5	3.5
Consumer price index (period average)	13.9	8.8	2.2	5.7	4.5	4.0	4.0	4.0	4.0
Consumer price index (end of period)	14.4	2.1	4.9	5.2	4.0	4.0	4.0	4.0	4.0
Money and Credit									
Domestic credit, net	29.9	14.7	5.0	9.1	6.9	7.0	6.8	6.9	6.9
Of which: Credit to private sector	17.4	14.7	15.9	10.0	8.0	8.0	8.0	8.0	8.0
Manat base money	-2.8	19.4	0.4	9.0	9.0	9.0	9.0	9.0	9.0
Manat broad money	23.8	19.6	9.0	10.6	7.9	8.4	8.3	8.4	8.4
Total broad money	23.6	5.3	11.9	9.2	6.5	7.0	7.0	7.0	7.0
External Sector									
Exports f.o.b.	94.6	-30.8	-8.8	10.8	-10.0	-9.9	-8.0	0.3	0.3
Of which: Oil sector	105.1	-34.0	-10.1	10.8	-12.0	-12.5	-10.7	-0.9	-0.9
Imports f.o.b.	29.7	21.4	2.7	12.0	0.9	3.0	5.1	6.5	6.6
Of which: Oil sector	56.3	12.2	-6.9	1.4	1.5	1.7	2.1	0.0	0.0
Real effective exchange rate	11.8	8.1	-1.1	…	…	…	…	…	…
Gross Investment	12.1	18.3	17.8	18.3	16.2	14.6	13.7	13.7	13.7
Consolidated government	8.0	12.2	11.3	11.7	10.0	8.8	8.1	8.1	8.1
Private sector	4.1	6.1	6.5	6.7	6.2	5.8	5.6	5.6	5.6
Of which: Oil sector	-6.3	-0.3	1.1	1.3	1.5	1.6	1.7	1.6	1.6
Gross National Savings	42.1	29.8	25.7	26.1	20.4	15.1	11.3	10.4	9.6
Consolidated General Government Finances 2/									
Total revenue and grants	32.1	40.6	37.1	34.4	32.8	31.0	29.8	29.5	29.2
Total expenditure	26.2	32.7	33.8	35.6	34.5	33.4	32.5	31.7	31.0
Current expenditure	18.2	20.5	22.5	23.9	24.4	24.6	24.4	24.4	24.0
Net acquisition of non-financial assets	8.0	12.2	11.3	11.7	10.0	8.8	8.1	7.3	7.0
Overall fiscal balance	6.0	7.9	3.2	-1.3	-1.7	-2.4	-2.8	-2.1	-1.8
Non-oil primary balance, in percent of non-oil GDP	-22.4	-22.1	-20.5	-22.1	-18.6	-16.3	-14.5	-12.7	-11.3
General government debt 3/	17.3	21.8	20.9	21.0	22.2	22.7	23.1	23.8	23.8
General government and government-guaranteed debt	26.9	28.9	27.6	27.6	28.6	28.9	29.1	29.6	29.4
External Sector									
Current account (- deficit)	29.8	11.5	7.8	7.8	4.1	0.5	-2.4	-3.3	-4.2
Foreign direct investment (net)	-6.5	-2.9	-0.7	-0.4	-0.2	0.0	0.2	0.4	0.5
Memorandum Items:									
Gross official international reserves (in millions of U.S. dollars)	8,996	11,281	10,960	10,760	10,560	10,360	10,160	9,960	9,760
in months of next year's non-oil imports f.o.b.	5.4	7.7	6.6	6.4	6.1	5.7	5.3	4.9	4.6
Nominal GDP (in millions of manat)	133,973	123,128	126,337	134,078	139,182	145,847	153,556	162,135	171,522
Nominal non-oil GDP (in millions of manat)	69,764	78,990	85,712	94,674	102,595	110,434	118,825	127,903	137,675
Nominal GDP (in millions of U.S. dollars)	78,807	72,429	74,316	78,870	81,872	85,792	90,327	95,373	100,895
Oil Fund Assets (in millions of U.S. dollars)	49,034	56,070	60,031	60,911	61,797	61,864	61,594	62,222	62,949
Assumed oil price, WEO plus $2-$3 premium (in U.S. dollars per barrel)	98.4	82.6	81.2	78.6	73.5	71.6	70.6	72.0	73.4
Assumed natural gas price, WEO plus a premium (in U.S. dollars per thousands of cubic meter	1340.0	460.1	389.0	517.4	424.7	342.2	290.2	290.2	290.2
Exchange rate (manat/dollar, end of period)	1.7	1.7	1.7	…	…	…	…	…	…

Sources: National authorities; and IMF staff estimates and projections.

1/ Includes the production and processing of oil and gas.

2/ Consolidates State Budget, State Oil Fund of Azerbaijan (SOFAZ), Nakhchevan Autonomous Region (NAK) and State Social Protection Fund.

3/ Starting in 2021, includes guarantees issued to Aqrakredit for its acquisition of distressed assets from the IBA.

Table 3. Azerbaijan: Financial Soundness Indicators, 2015-July 2024[1]

(Percent)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	Jul-24
Capital Adequacy										
Total regulatory capital to risk-weighted assets	16.8	9.1	14.4	21.1	22.2	25.1	19.1	19.3	17.5	17.5
Tier 1 capital to risk-weighted assets	14.2	8.2	13.0	16.9	18.3	21.6	16.0	15.2	13.5	14.6
Leverage ratio	12.6	7.4	7.1	10.6	11.2	11.4	11.1	9.6	9.8	9.5
Risk-weighted assets to total assets	66.1	59.1	55.6	58.3	56.6	51.9	61.8	57.3	65.2	67.8
Large exposures to Tier 1 capital	363.6	613.7	299.7	186.4	94.9	86.3	88.8	103.7	86.9	76.3
Asset Quality										
Nonperforming loans to total customer loans	13.9	21.0	18.7	14.5	8.3	6.2	4.5	3.8	2.6	2.7
Restructured loans to total customer loans	6.9	14.9	19.2	15.6	12.4	14.5	8.8	5.8	3.6	3.8
Earnings and Profitability										
Return on assets	-1.2	-5.3	3.1	1.0	1.8	1.8	1.8	2.2	2.3	2.3
Return on equity	-9.1	-62.5	35.8	7.5	12.9	13.4	13.6	18.9	19.6	20.2
Liquidity										
Liquid assets to total assets	14.6	16.4	19.9	24.2	28.6	32.9	36.1	36.6	26.7	23.3
Current assets to current liabilities (instant liquidity ratio)	43.3	72.5	69.5	55.1	55.9	58.0	60.2	60.4	56.3	48.7
Customer loans to customer deposits	122.9	97.1	67.1	67.9	69.9	68.3	61.8	58.0	67.1	74.7
Sensitivity to Market Risk										
Net open position in FX to total regulatory capital	-18.5	-314.5	-112.2	-42.4	-38.1	-28.2	-10.9	4.7	3.7	-1.2
Foreign currency-denominated customer loans to total customer loans	49.4	47.9	41.3	38.5	35.3	30.2	26.2	20.1	18.8	17.6
Foreign currency-denominated non-FI deposits to total non-FI deposits	78.7	70.7	71.4	64.8	60.6	55.4	48.4	48.0	39.3	38.8

Source: Central Bank of the Republic of Azerbaijan, IMF staff calculations.
1/ Based on prudential reporting methodology.

Table 4. Azerbaijan: Structure of the Financial System

	Number of institutions		Assets					
			Millions of AZN		Percent of total financial system assets		Percent of nominal GDP	
	2015	2023	2015	2023	2015	2023	2015	2023
Commercial banks[1]	43	23	34,916	49,178	87	66	64	40
Of which								
State-owned banks	2	2	13,914	14,664	35	20	26	12
Private banks	41	21	21,003	34,514	53	46	39	28
Of which								
Foreign-controlled banks[2]	8	5	2,624	2,916	7	4	5	2
Nonbank financial institutions	187	131	5,019	25,657	13	34	9	21
Of which								
Nonbank credit institutions	48	54	3,793	12,524	9	17	7	10
Of which								
Aqrarkredit[3]	1	1	3,186	11,765	8	16	6	10
Other nonbank credit institutions	47	53	607	758	2	1	1	1
Credit unions	109	40	1	13	0.00	0.02	0.00	0.01
Insurance companies[4]	27	19	495	1,275	1	2	1	1
Investment companies	…	13	…	121	…	0.2	…	0.1
State Social Protection Fund[5,6]	1	1	…	5,906	…	8	…	5
State funds	1	3	641	5,043	2	7	1	4
Of which								
Mortgage and Credit Guarantee Fund	1	1	641	2,793	2	4	1	2
Karabakh Revival Fund[6]	n.a.	1	n.a.	1,238	n.a.	2	n.a.	1
Entrepreneurship Development Fund	n.a.	1	n.a.	1,011	n.a.	1	n.a.	1
Azerpost[7]	1	1	88	774	0	1	0	1
Total financial system	230	154	39,935	74,835	100	100	73	61

Sources: Central Bank of the Republic of Azerbaijan, State Social Protection Fund, Mortgage and Credit Guarantee Fund of the Republic of Azerbaijan, Karabakh Revival Fund, Entrepreneurship Development Fund of the Republic of Azerbaijan, Azerpost, IMF staff estimates.

[1] In July 2024, one private bank was reorganized into a nonbank credit institution following a business decision made by its shareholders, reducing the number of banks to 22.
[2] Includes domestic banks with foreign shareholders owning more than 50 percent of outstanding shares, and local subsidiaries and branches of foreign banks.
[3] A state-owned nonbank credit institution that predominantly manages nonperforming loans transferred from the state-owned International Bank of Azerbaijan following the 2015-2016 crisis.
[4] Includes one reinsurance company. Assets refer to gross premiums.
[5] A state-owned pension fund. There are no private pension funds.
[6] Assets as at December 31, 2022.
[7] The national postal operator that also provides limited financial services, especially to rural areas, through its extensive network.

Table 5. Azerbaijan: COVID-19 Measures to Support the Financial Sector[1]

Measures	Description
Public guarantees	• Blanket deposit guarantee covering all manat and foreign currency deposits within a 10 percent and 2½ percent interest rate cap, respectively (until December 4, 2020).
Loan moratoria	• Banks and nonbank credit institutions were recommended to restructure loans of individuals and businesses affected by the pandemic and covered by the state support mechanisms. • Banks and nonbank credit institutions were allowed not to deteriorate loan classification category for restructured loans, thus, temporary easing the provisioning requirements: ○ Asset classification category for business loans to legal entities and individual entrepreneurs, eligible for state subsidies for interest payments, will not deteriorate, despite the borrower financial standing; ○ in case of restructuring, asset classification category of the business loans, eligible for state subsidies for interest payments and classified as standard as of March 1, 2020, will not deteriorate; ○ In case of restructuring, asset classification category of mortgage loans, financed through the state funds, classified as standard as of March 1, 2020, will not deteriorate. • Banks and nonbank credit institutions were recommended to abstain from accruing and charging penalties for delinquent loans and impairing borrowers' credit history.
Capital relief	Capital: • Total capital adequacy ratio was decreased by one percentage point (to 11% for SIBs and 9% for other banks). • Counter-cyclical capital buffer was set to zero. • Requirement to include operational and market risk in calculation of total regulatory and Tier 1 capital adequacy ratios was postponed. Risk weight: • Risk weight for mortgage loans issued through the banks' own resources was reduced from 100 percent to 50 percent. • Risk weight for micro-loans guaranteed by Agrarian Credit and Development Agency under the Ministry of Agriculture was reduced from 100 percent to 20 percent. • Risk weight for loans issued to medical equipment and supplies producers was reduced from 100 percent to 20 percent. • Application of higher risk weights for retail loans (based on borrower's DTI, loan maturity, interest rate and currency) was postponed.
Dividend restriction	• Banks and insurance companies were restricted to pay out dividends based on the financial results for previous years (extended until October 1, 2021).
Suspension of inspections	• Full-scope onsite inspections were postponed.

[1] Starting January 2021, the CBA implemented gradual exit from the pandemic relief package: inspections at credit institutions that were suspended in 2020 resumed; additional capital requirements for consumer loans were reinstated; blanket deposit guarantee was replaced with limited guarantee program (covering up to: (i) AZN 100,000 of retail deposits; (ii) AZN 20,000 of private entrepreneurs' deposits; and (iii) 100 percent of the funds owned by individuals in deposits of notaries, with additional caps depending on the interest rate); forbearance on regulatory requirements on loan classification and provisioning for restructured loans covered by the state support mechanisms was discontinued; and some of the postponed regulatory requirements were reintroduced (e.g., capital requirements for market and operational risks).

Table 6. Azerbaijan: Risk Assessment Matrix[1]		
Nature/Source of Main Threats	**Overall Level of Concern**	
	Likelihood of Realization of Threat in the Next 1–3 Years (high, medium, or low)	**Expected Impact on Financial Stability if Threat is Realized** (High, Medium, or Low)
• **Commodity price volatility**. A succession of supply disruptions (e.g., due to conflicts, uncertainty, and export restrictions) and demand fluctuations causes recurring commodity price volatility, external and fiscal pressures in EMDEs, contagion effects, and social and economic instability.	**High**	**High** • A sharp decline in oil and gas prices could worsen external and fiscal positions, and lead to a domestic economic slowdown. • In an extreme but plausible scenario, this may strain FX reserves and result in manat devaluation, posing challenges for banks and borrowers in meeting their foreign currency obligations. • The impact on banks' asset quality, profitability, and capital could hinder credit intermediation. • Currency devaluation could also reverse the considerable progress on de-dollarization as customers shift toward dollar deposits.
• **Intensification of regional conflicts.** Escalation of Russia's war in Ukraine or other regional conflicts and resulting economic sanctions disrupt trade (e.g., energy, food, tourism, and/or critical supply chain components), remittances, FDI and financial flows, and payment systems, and lead to refugee flows.	**High**	**Medium** • Higher energy prices are expected to support Azerbaijan's external and fiscal positions. However, the increase in the food imports bill could reignite inflationary pressures. • Trade disruptions due to additional sanctions or increased risk aversion may adversely impact certain businesses. Households receiving remittances from the affected countries may also be affected. These, in turn, could impact the repayment capacity of some businesses and households, and their deposits with banks. • Operational disruptions could arise for financial services provided out of affected countries. • Tightening financial conditions and rising risk premia would have a limited impact, given the low dependence on external financing and the limited presence of non-resident investors.

Table 6. Azerbaijan: Risk Assessment Matrix (concluded)

• **Abrupt global slowdown or recession.** Global and idiosyncratic risk factors combined to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and market fragmentation causing sudden stops in EMDEs.	**Medium**	**Medium** • An abrupt global economic downturn, along with weakness in trading partners, could negatively impact Azerbaijan's hydrocarbon exports, tourism, and remittances, affecting the external and fiscal positions, as well as domestic economic growth. • Weaker global demand could also result in depressed commodity prices. • The deteriorating capacity of households and businesses to repay debt could erode banks' capital and liquidity buffers. This, in turn, may lead to tighter credit conditions, hampering economic recovery.
• **Extreme climate events.** Extreme climate events driven by rising temperatures cause loss of human lives, severe damage to infrastructure, supply disruptions, lower growth, and financial instability.	**Medium**	**Medium/ Low** • Severe drought could affect agricultural output and increase food prices. • The repayment capacity of some borrowers in related industries may be affected, potentially leading to higher delinquencies and loan loss provisions for banks.
• **Loss of spending discipline, leading to a procyclical fiscal policy.** Higher oil and gas prices boost budget revenues, leading to increased spending pressures.	**Medium**	**Medium** • A procyclical fiscal policy could contribute to inflationary pressures and delay fiscal consolidation, weakening the long-term fiscal position and undermining fiscal rule credibility. • Procyclical fiscal policies may also lead to more pronounced swings in the economic cycle, potentially increasing the likelihood of loan defaults during downturns.
• **Weak SOE performance.** Failure to improve the financial performance of weak SOEs will result in continued losses, with negative impact on economic growth and on the effort to diversify the economy. It could also renew the accumulation of contingent liabilities to the budget.	**Medium**	**Low** • While government guarantees are limited and have not been increasing in recent years, the failure to strengthen SOEs could increase the risk of new guarantees being issued and existing guarantees being called, increasing government debt. • Weak SOEs could also adversely affect future economic growth and impede efforts to promote the private sector and diversify the economy. This, in turn, may hurt banks' asset quality, profitability and capital.

[1] This matrix is in line with the July 2023 G-RAM.

Table 7. Azerbaijan: Progress on Implementing the 2015 FSAP Main Recommendations[1]

Recommendation	Status
Banking Oversight	
Facilitate on-site supervision by exempting regulated financial institutions from the Law of the Republic of Azerbaijan on Regulation of Business Inspections and Protection of Interests of Businesses.	**Implemented.** • Until 2023 the Law of the Republic of Azerbaijan on Regulation of Business Inspections and Protection of Interests of Businesses with several exclusions was not applied to the financial market. With amendments dated July 6, 2023, to the Law of the Republic of Azerbaijan on Regulation of Business Inspections and Protection of Interests of Businesses inspections in financial markets was excluded and, since 2023 it has been conducted according to the "Law on the Central Bank of the Republic of Azerbaijan".
Introduce consolidated supervision as an overarching supervisory approach	**Planned.** • Consolidated supervision is one of strategic goals for banking, insurance and capital markets supervision in the Central Bank's Strategy for 2024-2026. • By mid-2025, the CBA plans to develop a regulatory framework for consolidated supervision. Delays in the implementation of this recommendation would be due to covid and its effects on the banking sector and the supervisory agenda, as well as the prioritization of other CBA's strategic projects.
Remove ability of CBA to provide subordinated loans and gradually disinvest from IBA capital	**Implemented.** • Capital Adequacy Regulation included definition and criteria of "special subordinated debt" that could be issued by the Central Bank of other state body and included in the Tier I capital. These provisions were included in the Rules in Dec 2009. In July 2012 the amended Regulation on Capital Adequacy was adopted, and provisions related to special subordinated debt, including Central Bank's ability to provide subordinated loans for use in the calculation of capital excluded. Upon adoption of amendments to the Regulation corrections were made to prudential reporting in 2013. Because of that correction, subordinated debt issued by CBA to IBA was excluded from the IBA's Tier I capital. • Such loans provided to IBA by the CBA (amount outstanding at the time of 2015 FSAP) were gradually discontinued and fully closed down by February 2017.
Enhance transparency on beneficial ownership by revising the Commercial Secrets Law	**Implemented.** • Relevant changes were made to the Law on Commercial Secrets in 2016 in order to overcome the 2015 FSAP shortcoming that the disclosure of beneficial owners of banks and related parties was hindered by the Law on Commercial Secrets that prescribed that 'data about shareholders of commercial legal entities and their shares in the authorized capital" as commercial secret.

Table 7. Azerbaijan: Progress on Implementing the 2015 FSAP Main Recommendations (continued)

Enforce corrective measures, particularly in compliance with prudential norms	**Partially implemented.** • The authorities consider this recommendation as implemented on grounds that CBA has enhanced its supervision approach to weak banks non-compliant with the prudential requirements and strengthened requirements to banks administrators. Since 2015 licenses of 18 banks were revoked, 1 bank was reorganized into nonbank credit institution and 1 bank's license revoked based on the bank's request. Additionally, administrative sanctions that were applicable to the controlled subjects were made stricter. • Even though several legal and regulatory improvements have been made in order to strengthen the CBA´s powers to establish corrective measures and banks' regulatory compliance gaps have been reduced, according to the on-situ supervisory results of banks, it is necessary to develop a formal and risk-sensitive supervisory intervention framework (including guidelines for the application of restrictive measures and sanctions where appropriate), as part of the RBS project, and apply this framework on an ongoing basis and using a sound supervisory judgment. With these elements a general improvement in banks' regulatory compliance levels will be achieved.
Establish supervisory regimes for market, operational, interest rate and country risk	**Partially implemented.** • In July 2021 capital charges for operational and market risks were included in the calculation of capital adequacy. Development of the regulatory requirements for operational and market risks management in banks is among the work priorities for 2024-25. Draft regulations on both risks were developed in 2021 and discussed with IMF experts, however certain renewal for the drafts is required (specifically for market risk taken into account development of new legislation allowing banks to trade securities). At the same time CBA requires banks to stress test for operational and market risks within the semiannual bottom-up stress-testing. • In the period Q1 2024 – Q3 2025, the CBA plans to issue the regulatory framework for the operational and market risk management, as well as regulatory standards for bank's stress-testing. • The issuance of specific regulation on country risk and interest rate risk is pending.
Raise quality of corporate governance, particularly by requiring independent and qualified non-executive directors	**Partially implemented.** The authorities consider this recommendation as implemented based on the following: • In September 2023 a new edition of Corporate Governance Standards in Banks was issued by the CBA. • The new Standards include: ○ Principle of division between supervisory and executive management functions in bank, including requirements to form Supervisory Board and Supervisory Board Committees (mandatory Committees Risk Management, Audit and Corporate Governance) with non-executive members only. ○ Requirement to have independent external member of Supervisory Board (1/3 of the board) and independent external member of Supervisory

Table 7. Azerbaijan: Progress on Implementing the 2015 FSAP Main Recommendations (continued)	
	Board Committees. ○ Criteria of independency of external members ○ Updated requirements to mandatory Committees composition, including requirement to have at least 1 independent Supervisory Board member present in all mandatory committees ○ Transformation of Remuneration Committee to Corporate Governance Committee with expanded authorities and responsibilities ○ On the executive side: reviewed requirements to CRO, ensuring CRO not to hold other executive positions ○ Increased focused on compliance function, requirements for chief compliance officer and compliance committee (committee is not yet mandatory) ○ Requirement to address sustainable development issues (including ESG, gender diversity) in banks' strategies and risk management policies ○ Improved reporting to the Regulators (including access to Supervisory Board and Committees protocols) and publicly disclosed information (in accordance with Basel III, Pillar III) ○ Amendments to the requirements on renumeration practices (identification of material risk takers, separating stable and variable bonuses, requirement for bank to comply with all prudential norms for bonuses to be paid, connecting paying out bonuses with a bank's financial results confirmed by auditors). However, this recommendation is considered partially implemented because: • The implementation of these new corporate governance requirements by banks is at an early stage. Banks still have until September 2024 to complete compliance with the requirements established in said standards, including the requirement for independent directors. The 2015 FSAP recommendation also addresses the improvement of banks' corporate governance, in practice, especially in the case of medium-sized and small banks, which is still subject of the supervisory cycle (applying the new regulatory standards) and the ongoing supervisory measures imposed by the CBA.
Strengthen the governance structure of the CBA by appointing non-executives to the two vacant positions and establishing an Audit Committee	**Not implemented.** • According to the amendments to the Law on the Central Bank of the Republic of Azerbaijan the number of board members was increased to nine persons, of which two external members However, there are still vacant positions on the CBA Management Board. Likewise, the Law on the Central Bank does not yet contemplate the establishment of an Audit Committee. • Therefore, this recommendation will be considered implemented when the appointment of all members of the CBA Management Board is completed and the legal modifications and operational actions to establish a CBA Audit Committee have been carried out.

Table 7. Azerbaijan: Progress on Implementing the 2015 FSAP Main Recommendations (continued)

Provide CBA power to raise prudential standards for individual banks and banking groups	**Partially implemented.** The authorities consider this recommendation as implemented based on the following: • According to the Article 34.5 of the Law on Banks and Article 49.2 of the Law on the Central Bank, the CBA has the right to define different norms and requirements for banks in relation to systemically important banks than the norms and requirements established under Article 34.2 of the Law on Banks. • After the amendments to the Law on the Central Bank of the Republic of Azerbaijan and the Article 34.2 of the Law on Banks, the Central Bank shall be entitled to establish standards and requirements on systemically importance and (or) risk profile of banks that are different from already established standards and requirements. • According to its power, CBA adopted specific rules mentioned below: ○ There are additional capital requirements and exposure requirements for systemically important banks (total regulatory adequacy ratio includes 2% additional buffer for SIBs (12% vs 10% for other banks), Tier 1 capital adequacy 6% for SIBs, 5% for other banks, leverage 5% for SIBS, 4% for other banks. ○ Single borrower exposure of one D-SIB to another is limited to 15% (total exposure limit 25%). ○ There are additional corporate governance requirements to SIBs (for example, appointment of Corporate Secretary, etc.). • However, this recommendation is considered partially implemented because: ○ The new legal power to use supervisory judgment to apply stricter prudential requirements is not yet implemented in practice, as the methodology for its application is still in progress. ○ The application of stricter prudential requirements is only limited to individual banks and not to banking groups, because the consolidated supervision framework is also still in progress.
Strengthen identification and assessment of the suitability of shareholders and beneficial owners	**Partially Implemented.** The authorities consider this recommendation as implemented based on the following: • According to the amendments to the laws “On Banks”, “On NBCI’s” identification and assessment of the suitability of shareholders, including beneficial owners are required for authorization and obtaining qualifying holding of controlled subjects. • According to the Article 7.2 of the Law on Banks the Central Bank, when reviewing the appeal for a bank license and permit, may receive information on financial standing of share owners in bank capital and beneficial owners; whether qualifying holding owners (if a legal entity, heads of its executive bodies), beneficial owners and officers are fit and proper persons and the source of charter capital of the bank from independent and reliable sources, as well as from related public authorities (institutions). Public authorities

Table 7. Azerbaijan: Progress on Implementing the 2015 FSAP Main Recommendations (continued)	
	(institutions) should provide the information requested by the Central Bank within seven working days. Except for state secrets, public authorities (institutions) may not refuse to provide the requested information referring that the requested information qualify for a commercial secret, a tax secret or other confidential information protected by law. 7.2-1. Article 7.2 herein shall apply to the persons willing to subsequently acquire qualifying holding in the bank (if a legal entity, heads of its executive bodies), beneficial owners, newly appointed officers, and heads of executive bodies of the legal entity that becomes the bank's subsidiary. • For the purpose of strengthening identification and assessment of the suitability of shareholders and beneficial owners, sectoral legislative acts of the Republic of Azerbaijan have been updated on determining whether the owner of a significant participation share, the beneficial owner and persons on management functions meet to fit and proper requirements. In this regard, also "Methodological guidance on the examination of data during the review of applications for obtaining licenses, permits or other legal documents in the field of financial markets" was developed by CBA. • Sectoral legislative acts*: Law on Banks*- https://e-qanun.az/framework/5825 However, this recommendation is considered partially implemented because: • The following aspect recommended by the 2015 FSAP is still in progress: amend the law to adopt a provision that requires banks to notify the CBA in the event of any material information which may negatively affect the suitability of a significant shareholder. • On this point, the CBA considers that said provision is not necessary because the following two provisions already exist: (i) Article 25 of the LB. The Supervisory Board of the bank shall in case of revealing breach of the existing legislation by the bank, accordingly notify the general meeting of shareholders, the Audit Committee and the Management Board, and submit a notification to the Central Bank on violations of the requirements of the banking legislation and the Laws of the Republic of Azerbaijan on Prevention of Legalization of Criminally Obtained Property and the Financing of Terrorism' and 'on Targeted Financial Sanctions' and (ii) Article 16.2 of the CBA's "Corporate Governance Standards in Banks". The bank's compliance function: …informs the Central Bank on risks and shortcomings detected and likely to have adverse effect on bank's sustainability indicators, as well as actions taken or to be taken on their elimination. Additionally, as indicated in the MONEYVAL Mutual Evaluation Report (December 2023), the CBA's capabilities should be strengthened to ensure that their licencing system includes adequate checks in the context of bank ownership and control, including in relation to beneficial owners and association in all cases, and implement a system for liaising with foreign authorities to ascertain whether they have relevant information for assessing their fit and properness.

Table 7. Azerbaijan: Progress on Implementing the 2015 FSAP Main Recommendations (continued)

Systemic Financial Risk	
Establish interagency body for crisis preparedness and management, and sharing supervisory information on a regular basis	**Partially Implemented.** • The Economic Board, which replaced the Financial Stability Board, has a very broad mandate and membership structure with a political overlay that might cloud decision-making and impair the independence of financial safety net stakeholders. • ADIF, which is a crucial financial safety net player, is not included among the members. ***Authorities' Views*** The authorities concurred, noting that: • Financial Stability Board was established. Now it is renamed to Economic Board. The Board headed by the Prime Minister includes representatives of all relevant economic agencies in the country, including Central Bank, Ministries of Finance, Economy, Labor and Social Protection, State Oil Fund. It gathers regularly to discuss economic issues that require interagency coordination and joint position.
Provide CBA explicit mandate for financial stability, financial stability unit within CBA	**Implemented.** CBA explicit mandate is prescribed in the Article 4.2 of the Law on the Central Bank of the Republic of Azerbaijan. CBA has established Financial Stability Department. Functions of the department and its relations with other structural units within the Bank is clearly defined in the approved department's charter.
Financial Safety Net, Resolution of NPLs, and Systemic Liquidity Management	
Give the CBA full powers for bank resolution without resorting to the court system and the full range of tools necessary for resolution	**Partially implemented:** • The scope of the resolution regime does not cover bank holding companies and significant non-regulated operational entities within the group. • Specific resolution powers are subject to court approval. • The regulatory framework for resolution planning hasn't been finalized yet. ***Authorities' Views*** The authorities concurred, noting that: • New articles have been added to the "Law on Banks" regarding with the resolution. Also 3 regulations related to resolution were adopted in 2018, namely regulation "on substantiating expenses for selecting one of the resolution methods and conducting their comparative analysis", "on defining the resolution actions on insolvent bank and conducting auction", " on establishing a bridge bank, issue of shares, licensing and regulating bridge bank".

Table 7. Azerbaijan: Progress on Implementing the 2015 FSAP Main Recommendations (continued)	
	• In addition to that Resolution Department was established in the CBAR. The Department is developing regulatory framework for resolution planning in the banks. • Dependency of the CBA powers on the court decision: ○ According 57.8 of the "Law on Banks": a court may terminate payments on deposits of legal entities and individuals and bank's other liabilities totally or partially (impose moratorium). ○ According 57-7.1 of the "Law on Banks": The temporary officer shall sell the insolvent bank to an investor by approving with a court decision in line with the insolvent bank's resolution related actions plan. ○ According 59.1 of the "Law on Banks": Except for voluntarily liquidated banks or those announced bankrupt, the Central Bank shall apply to court on forced liquidation of the bank, the license of which is revoked for other reasons as stipulated in Article 16 herein, and appointment of liquidator(s). ○ According 60.2 of the "Law on Banks": Banks may be announced bankrupt only as per this Law at the decision of the court. An out-of-court procedure for declaring the bank bankrupt shall not be allowed.
Formalize borrowing arrangements with the CBA, enabling DIF funds to be applied for all resolution procedures on a least-cost basis	**Partially implemented:** • ADIF's borrowing arrangements with the CBA need additional safeguards to protect central bank balance sheet. There should be a clearly defined procedure for the documentation of the borrowing arrangement and preconditions for activating the borrowing. • As for determining the amount to be borrowed, the period within which the CBA must provide funds to ADIF and the terms and the determination of terms and conditions for borrowing. • Deposit insurance funds cannot be applied for resolution procedures on a least-cost basis, and if that is not the case, the underlying reasons. ***Authorities' Views*** The authorities concurred, noting that: • On 14.10.2016 new Article 54.3-1 added to the Law on the Central Bank and on 19.01.2016 new article 17.2 added to the Law on Deposit Insurance, on that the Central Bank provides loan funds to the Deposit Insurance Fund. • Moreover, the Deposit Insurance Fund is not involved in the resolution process.

Table 7. Azerbaijan: Progress on Implementing the 2015 FSAP Main Recommendations (continued)

Sign an MOU between DIF and CBA to ensure automatic exchange of information with a view toward eventually introducing risk-differentiated deposit insurance premia	**Not implemented.** • The project is still on-going. ***Authorities' Views*** The authorities concurred, noting that: • A project has been prepared on this issue. Discussions are currently underway on the final version of the project.
Set out ELA preconditions, indicative term sheet for lending, and requiring banks to be pre-positioned for sale and repurchase arrangements with high quality assets	**Partially implemented:** • The Regulation for Issuing Loans to Banks by the Central Bank of Azerbaijan covers the provisions relating to lender of last resort/emergency liquidity assistance, but the framework should be enhanced on several parameters including the eligibility criteria, collateralization, collateral valuation and government indemnity. ***Authorities' Views*** The authorities were of the view that this recommendation has not been implemented, noting that while the possibilities of the lender of last resort are provided for in the law, emergency liquidity assistance facilities are not available.
For systemic banks develop bank-specific resolution plans based on comprehensive resolvability assessments that seek to minimize fiscal risk and moral hazard	**Not implemented.** • The project is still on-going. ***Authorities' Views*** The authorities concurred.
Anti-Money Laundering and Counter Financing of Terrorism	
Continue to address AML/CFT deficiencies on adequate criminalization of money laundering, transparency of beneficial ownership, and preventive measures, including sanctions.	**Partially implemented.** Azerbaijan's AML/CFT framework underwent a comprehensive assessment by MONEYVAL, as published in MONEYVAL's 2023 report. The report sets out considerable improvements in the AML/CFT legal framework overall, however, certain technical gaps in relation to the money laundering offence and related sanctions remain. Azerbaijan received a moderate rating on effective implementation of preventive measures and on the transparency of legal entities and arrangements.

Table 7. Azerbaijan: Progress on Implementing the 2015 FSAP Main Recommendations (concluded)	
	Authorities' Views The authorities recognize the gaps identified in MONEYVAL's assessment. Azerbaijan has an existing National Action Plan in relation to AML/CFT for 2023-2025, and has developed an additional short-term plan to address deficiencies identified in MONEYVAL's assessment. In the context of the financial sector, regulations were introduced for regulated entities to submit suspicious cases to the Financial Intelligence Unit, supported by guidance (a list of red flags) for some financial institutions. The FIU also developed a methodology to assist regulated entities in identifying beneficial owners of legal entities. Supervisors' resources were enhanced, and the methodologies for AML/CFT risk-based supervision and fitness and propriety in bank ownership are planned for improvement through technical assistance. Information on recent sanctions imposed on financial institutions are now published online. The National Action Plan also includes proposals for setting up a database on beneficial owners.

[1] Based on inputs and discussions with the authorities during the FSAP First Mission (May 20-31, 2024).

Table 8. Azerbaijan: Progress on Implementing the 2022 Development Module FSAP Main Recommendations on Financial Sector Stability[1]

Recommendations	Responsible Authority	Timeline	Status
Nonperforming loan (NPL) management and resolution			
Strengthen credit risk management requirements for banks, incl. asset classification & NPL management (workout units, NPL reduction strategies)	CBA	MT	**Partially implemented.** • The new credit risk management standards (including NPL management) are recent and the conduct of a focused credit risk on-site examination across the banking industry is still in progress. • The CBA has not required banks with high NPLs to come up with NPL resolution strategies to reduce their NPLs to manageable levels.
Reform the enforcement procedures to minimize process delays (for loan defaults)	MOJ	MT	**Partially implemented.** • The authorities are currently working on centralizing the electronic auction mechanism for asset recovery and redrafting the Insolvency Ac • t and procedures to speed up the process.
Strengthen the institutional capacity to administer insolvency procedures	MOJ	LT	**Partially implemented.** • There is a working group, including the participants from Ministry of Justice and the Central Bank, with the purpose of strengthening the institutional capacity to administer insolvency procedures.
Banking regulation and supervision			
Update laws to ensure CBA (as a financial supervisor) has adequate powers, independence, resources and legal protection	CBA / Parliament	ST	**Partially implemented.** The CBA considers this recommendation as implemented because with the amendments to the Law on CBA, dated July 6, 2023, and amendments to other relevant laws adequate powers, independence and legal protection were prescribed in the legislation.

Table 8. Azerbaijan: Progress on Implementing the 2022 Development Module FSAP Main Recommendations on Financial Sector Stability (continued)

			However, this recommendation is considered partially implemented because these relevant aspects is still in progress (LCBA amendments): • Strengthen the eligibility criteria to be eligible for membership of the CBA's Management Board (MB). • Establish a cooling-off period for MB members and strengthen the disclosure of direct or indirect financial interests of MB members. • Strengthen the process of appointing and removing the CBA Management Board (MB) members (transparency and limited set of reasons for dismissal). • Enhance the powers of CBA to deal with shortcomings on performance of external auditors. • Specify that the CBA will cover the expenses incurred as a result of the criminal, civil, or administrative proceedings against the Management Board members and the staff of the CBA.
Conduct a focused credit risk on-site examinations across the industry	CBA	ST	**Implemented.** • Currently there are 23 banks in the banking sector. During the 2021 - 2023 years in 21 banks credit risk was assessed as a part of full comprehensive and targeted on-site inspections. • 3 out of 21 banks were SIB. In January 2024 a full comprehensive on-site examination started in 4th SIB and credit risk is going to be one of the areas. • As such, considering the progress made by the CBA and that the credit risk on-site examinations is a continuous task as part of the supervisory cycle, this recommendation is considered implemented.

Table 8. Azerbaijan: Progress on Implementing the 2022 Development Module FSAP Main Recommendations on Financial Sector Stability (concluded)

Introduce a rigorous consolidated regime for mixed and financial conglomerates	CBA	MT	**Planned.** By mid-2025, the CBA plans to develop a regulatory framework for consolidated supervision. According to the BCA, delays in the implementation of this recommendation would be due to covid and its effects on the banking sector, as well as the prioritization of other strategic projects.
Step-up efforts to shift from compliance to risk-based supervision	CBA	MT	**Partially implemented.** As part of the Financial Sector Development Strategy (FSDS), the CBA is working on the implementation of a new risk-based supervision (RBS) model according to the best international standards and with technical World Bank (WB) support. To this date, the RBS model approach has been developed and submitted to the CBA Management Board. The first pilots using the new RBS are scheduled for the beginning of 2025.
Formalize a framework for supervisory interventions and step-up enforcement	CBA	ST	**Planned.** Authorities mention that this recommendation will be addressed within RBS project. In this mission, the lack of a framework for supervisory interventions and step-up enforcement has been also addressed and complementary aspects have been recommended.

[1] Based on inputs and discussions with the authorities during the FSAP First Mission (May 20-31, 2024).

Appendix I. Stress Testing Matrix

<table>
<tr><th colspan="2">Bank Solvency Stress Test</th></tr>
<tr><td>Institutional perimeter</td><td>All 23 commercial banks.</td></tr>
<tr><td>Data and starting position</td><td>Bank-by-bank regulatory and supervisory data on a solo basis, supplemented by additional data surveyed from banks by the authorities.
Cutoff date: End-March 2024.</td></tr>
<tr><td>Methodology and risk factors</td><td>Main components of the balance sheet, income statement, and capitalization of individual banks were projected using satellite models involving econometric and structural approaches, linking macrofinancial variables with drivers of each component.
No intervention by the government or the CBA, nor management actions by the banks to mitigate the impact of the adverse scenario. For conservatism, hedges were assumed to be ineffective.
Balance sheet
A proportion of outstanding undrawn guarantees and credit lines was assumed to be drawn down under the adverse scenario. Other than the new credit exposures arising from such drawdowns, banks were assumed not to issue additional loans. Asset growth was also influenced by valuation gains/losses on foreign-currency-denominated assets due to changes in exchange rates. Deposits were assumed to grow at a rate necessary to equate assets to the sum of liabilities and equities. Like assets, liability growth was also influenced by exchange rate changes on foreign-currency-denominated liabilities.
Credit risk
Credit loss calculations accounted for additional provisions for newly defaulted loans, as well as evolving provision stocks for existing loans and the impact of write-offs. Write-offs were assumed to equal any reduction in NPLs over the stress test horizon.
NPL ratios were used for credit risk modeling due to the unavailability of data on PDs and quality issues with data on write-off and cure flows. Panel regression models were estimated for five segments: consumer loans and business loans, each in manat and foreign currency, and mortgages in manat. NPL ratios for mortgages in foreign currency were not modeled due to the negligible portfolio size; instead, they were assumed to remain constant under the baseline scenario and increase to 100 percent under the adverse scenario. The FX-induced credit risk was captured by including exchange rate variables as regressors of the satellite models.</td></tr>
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<table>
<tr><th colspan="2">Bank Solvency Stress Test</th></tr>
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LGDs for the mortgage segment were projected as a function of the LTV ratios and expected recovery rates of the collaterals following Gross et al. (2020). Due to data limitations, LGDs for consumer and business loan segments were projected by judgmentally setting the haircuts on collateral pledged on NPL at 50 percent for the baseline scenario and 100 percent for the adverse scenario. LGD for uncollateralized exposures was set at 100 percent under both scenarios.
To account for the uncertainty surrounding collateral valuations, bank-segment-specific provision coverage ratios were subject to floors, as guided by provisioning requirements under the national regulation.

Interest rate risk

Interest income and expense were projected by applying scenario-dependent interest rate paths to interest-bearing assets and liabilities. Using an econometric approach, effective interest rates were modeled as a function of their autoregressive lags and macrofinancial variables. The latter included average interbank rates to capture the pass-through effects from policy or market rates. Nonperforming exposures were assumed not to generate interest income. On top of this, under both baseline and adverse scenarios, a proportion of manat demand deposits was assumed to shift from non-interest-bearing to interest-bearing accounts. This assumption reflects the expectation that the existing trend of such a shift will continue moving forward.

Market risk

Mark-to-market valuation gains/losses on HfT and AfS debt securities were projected using a modified duration approach and reflected in trading income and other comprehensive income, respectively.
Valuation gains/losses on FX positions—predominantly in US dollar—were calculated by applying the projected USD/AZN exchange rate paths to the overall net open FX position.
Due to the small size of banks’ equity exposures, equity risk was not considered materially relevant and was therefore excluded.

Other non-interest income and expense

Fee and commission income and expense were projected separately as a function of their autoregressive lags and macrofinancial variables using an econometric approach. Remaining income statement items—mostly operating expense—were assumed to grow proportionately with the balance sheet, adjusting for any one-off income or expense.

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Bank Solvency Stress Test	
	Taxes and dividends • Income taxes were calculated using historical effective tax rates. Loss-making banks were assumed not to pay taxes. • Banks were assumed to pay out dividends only if they record a net profit, their total comprehensive income—the sum of net income and other comprehensive income—is positive, and they would continue meeting capital requirements. *RWA* • Credit RWA was projected by applying constant densities, calculated at the cutoff date, to the projected loans, net of provisions for NPLs. Credit RWA for off-balance-sheet exposures was adjusted to reflect changes in the outstanding undrawn guarantees and credit lines. Credit RWA for other asset segments was assumed to remain unchanged. • Market RWA was determined by the evolution of the net open FX position, consistent with the national regulation. Operational RWA was assumed to grow in tandem with the balance sheet.
Scenarios	• Baseline scenario is aligned with the April 2024 World Economic Outlook and Article IV team's projections of GDP and inflation as of May 2024. • One bespoke adverse scenario addressing the most relevant risks and vulnerabilities confronting the financial system, produced using a two-country empirical IPF model, as detailed in Chen et. al (2023). The scenario featured an abrupt global recession, triggering a plunge in oil and gas prices. Deterioration in external and fiscal positions, along with eroding business and consumer confidence, would lead to a contraction in the domestic economy. The manat was assumed to devalue against the US dollar to restore external balance. The weaker currency would, in turn, pass through to higher domestic prices, prompting a series of monetary policy tightening measures. • To address the relatively mild initial projections of CPI inflation and interest rates from the IPF model, bridge regressions were employed to derive more severe projections of these variables. • Horizon: Three years.
Sensitivity analyses	• Higher FX risk from potential shifts in deposits from manat to US dollars was simulated to emulate conditions similar to those observed during the 2015 devaluations. All banks were assumed to experience the same proportion of shifts during Year 2 of the adverse scenario, without making any other balance sheet adjustments. The impact of additional valuation losses was evaluated in conjunction with the solvency stress test results.

Bank Solvency Stress Test	
	• Potential losses associated with liquidity-solvency interaction were considered by projecting additional funding costs from pledging HtM bonds to access central bank standing facilities to meet funding withdrawals after exhausting other liquid assets. The impact was applied at the end of Year 2 of the adverse scenario, over and above the solvency stress test results. The calibration of the funding withdrawals was based on a "reverse stress test" approach, informed by the liquidity stress tests. Banks were assumed to meet funding withdrawals by first using cash and cash equivalents, followed by HfT and AfS bonds, and finally resorting to HtM bonds. Banks that exhausted their cash and securities were presumed to obtain additional liquidity through ELA with expanded eligible collateral. The costs of accessing the standing facilities and ELA were set at 100 basis points above the short-term interest rates. • Credit concentration risk was assessed by simulating hypothetical simultaneous defaults of the five largest credit exposures for each bank. Due to data limitations, these exposures were assumed to be fully uncollateralized, and banks were assumed to provision 75 percent of the defaulted amount. The impact of additional provisions—assumed to reduce banks' capital directly—and changes in credit RWA, was assessed separately from the solvency stress test results. • Deterioration in credit quality of restructured loans was simulated through downgrades in asset classification. The impact of additional provisions—assumed to reduce banks' capital and RWA—was assessed separately from the solvency stress test results.
Hurdle rates	• National regulations on total regulatory capital, Tier 1 capital, and leverage ratios—differentiated between D-SIBs and other banks—and minimum amount of total regulatory capital. • Countercyclical capital buffer requirement—currently set at zero—was assumed to remain unchanged. No capital conservation buffer requirement in place.
Output presentation	• Evolution of aggregate capital ratios and key drivers. • Number and market share of banks below the hurdle rates. • Aggregate capital shortfall.

Bank liquidity stress test	
Institutional perimeter	• All 23 commercial banks.
Data and starting position	• Bank-by-bank regulatory and supervisory data on a solo basis. • Cutoff date: End-March 2024.
Methodology and risk factors	• LCR- and cash flow-based analyses, separately for manat and foreign currency, capturing funding and market liquidity risks. *LCR-based* • Parameters stipulated in the national regulation were adopted as a starting point. • Six scenarios: three outflow scenarios, each assuming higher run-off rates for retail funding, unsecured wholesale funding, and both, respectively, while keeping all other parameters fixed. The same exercise was repeated with additional haircuts on unencumbered debt securities. *Cash flow-based* • Horizons: 1-week, 2-week, 1-month, 2-month, 3-month, 6-month, and 12-month. • Run-off rates for the 30-day time bucket were at least as high as those under the LCR. Calibration for other time buckets followed a rule of thumb such that the cumulative outflows over a six-month horizon amounted to at least 25 percent of the initial stock of liabilities. Undrawn guarantees and credit lines were assumed to be drawn down. • Banks were assumed to roll over at least 50 percent of maturing loans to households and businesses. • Haircuts on unencumbered debt securities were judgmentally set at 20 percent across all types of instruments. • No extraordinary intervention by the government or the CBA, nor new borrowings by the banks. The analysis was performed under three scenarios: required reserves held at the CBA were not released, half of the reserves were released, and all reserves were fully released, accounting for the potential lowering of reserve requirements during systemic liquidity stress events while also considering interactions with monetary policy.
Sensitivity analyses	• Reverse liquidity test was conducted by applying progressively higher run-off rates on deposits. All other parameters were kept fixed. The results were measured in terms of the cumulative deposit outflow rate at the point when the CBC was fully depleted at the banking sector level. • Deposit concentration risk was assessed by simulating hypothetical simultaneous and sudden withdrawals of the five largest deposits of each bank, assuming no inflows or other outflows. The withdrawals were then compared against the CBC.

Bank liquidity stress test	
	• Liquidity capacity to withstand a sudden increase in deposit dollarization was assessed by applying several shifts in customer deposits from manat to US dollars. To mitigate currency mismatches, banks were assumed to liquidate their CBC in manat to purchase US dollars, applying haircuts of 20 to 60 percent on unencumbered debt securities. Liquidity surpluses or shortfalls were determined by comparing the amount of manat required to purchase US dollars with the available manat CBC. No other inflows or outflows were considered.
Hurdle rates	• LCR-based: transitional minimum requirements as of June 2024—differentiated between D-SIBs and other banks. Despite no minimum requirements being imposed on the manat LCR under the regulation, the same hurdle rates were used for the analysis. • Cash flow-based: insufficient CBC to offset cumulative negative liquidity gaps.
Output presentation	• Evolution of aggregate liquidity indicators and key drivers. • Number and market share of banks below the hurdle rates. • Aggregate liquidity shortfall.
Interconnectedness analysis	
Institutional perimeter	• All 23 commercial banks, all 18 insurance companies, and all 54 nonbank credit institutions.
Data	• Supervisory data on bilateral exposures—without a breakdown by type of instrument and currency—among institutions on a solo basis.
Methodology and risk factors	• Network model based on Espinosa-Vega and Solé (2010), capturing credit and funding risks.
Hurdle rates	• National regulations on total regulatory capital ratio.
Output presentation	• Network charts. • Contagion and vulnerability indices.

Appendix II. Banking Regulation and Supervision: Governance, Independence, Resourcing, and Supervisory Approach

1. Further enhancements in the following key areas would reinforce CBA's effectiveness, in its role as a banking supervisory authority:

- **Amending the LCBA to ensure a robust governance, accountability and independence of the CBA.** As transitioning to a new RBS model implies the need for a more comprehensive and intrusive supervisory approach, the CBA should enhance its institutional framework to address the 2022 FSAP recommendations relating to: (i) professional expertise criteria for its Management Board (MB); (ii) legal provisions on cooling-off periods for MB members; and (iii) transparency on appointing and removing MB members, including setting limited reasons for dismissal and public disclosure of the reasons for removal. On CBA's accountability, its current legal provisions should be enhanced in line with transparency and public disclosure standards to prioritize public accountability and/or apply robust disclosure policies, which also safeguards independence, in substance and form.
- **Improving commercial banks' corporate governance and risk culture**. The recent CBA enhanced standards on corporate governance and risk management should be accompanied by prompt transition to RBS assessments, including early and intrusive supervisory intervention. This requires the development of a clear and structured framework to escalate supervisory measures (including early intervention, sanctioning, and resolution tools), and the supervisors' ability and willingness to apply this framework on an ongoing basis, using sound supervisory judgments. These elements will enhance market discipline, mitigate risks of supervisory forbearance, and strengthen the CBA's supervisory reputation.
- **Improving the supervisory procedures and criteria to assess compliance with provisions on related parties transactions.** Currently, the supervisory criteria and procedures to review the compliance of the legal and regulatory framework on related parties exposures—within the CAMELOS methodology[1] and on-site supervision manual—are quite general. Given the complexity and relevance of these assessments, the CBA should develop a comprehensive and ad-hoc methodology that contains detailed steps to follow, information sources, and criteria to apply (off-site and on-site supervision), including early warnings or "red flags", e.g., disbursement of new loans to borrowers with concessional conditions.

[1] Refers to: (C) Capital adequacy; (A) Assets Quality–Credit Risk; (M) Management–Corporate; Governance; (E) Earnings–Profitability; (L) Liquidity risk; (O) Other risks; (S) Sensitivity–Market risk.

- **Integrating bottom-up stress-tests into supervision process.** Banks are required to conduct bottom-up stress tests twice a year. The CBA provides macro projections and assesses their stress test models and results. The FSAP's bank solvency stress test results reinforced the importance of prioritizing this integration to support forward-looking risk assessment, guide internal capital adequacy assessment (ICAAP) and supervisory review of capital adequacy (Pillar 2 of Basel Framework).
- **The CBA should develop its inherent risk assessment and ICAAP benchmarking approaches.** The interest rate risk in the banking book (IRRBB) is one of the risk parameters of the regulatory stress test (duration analysis and impact of interest rate change on credit portfolio). Therefore, the CBA could use the results of the stress test to evaluate banks' management of the IRRBB—based on internal policies, procedures, and good practices—and prioritize oversight on banks with high exposure to such risk. The implementation of shock scenarios and identification of outlier banks should use BCBS IRRBB standards as the main reference. In the medium term, as IRRBB is not part of the risks covered under Pillar 1, this risk and other material additional risks could be part of the ICAAP and supervisory capital assessments in line with Pillar 2 of Basel Framework.
- **Strengthening CBA resources to support effective implementation of new RBS model (more comprehensive, structured, risk-sensitive and intrusive banking supervision).** Enhancing human resources—in terms of numbers, specialization and range of skills—would entail designing and executing proper recruitment process and training programs, and adequate financial resources.

Appendix III. Financial Safety Net, Bank Resolution, and Crisis Management

1. **Since the 2015 FSAP, the authorities have comprehensively updated the legal, policy, and procedural framework for bank resolution and taken measures in enhancing the lender of last resort function.** Specifically:

- The 2017 LB amendment introduced additional resolution powers—broadly following the FSB Key Attributes—including the appointment, powers and responsibilities of the temporary administrator; temporary public funding; and liquidation and appointment of ADIF as the liquidator.
- Amendments in the Law on Deposit Insurance (LDI) covers ADIF's borrowing from the CBA against government indemnity.
- CBA is no longer authorized to provide subordinated loans to banks with capital adequacy problems (2016 LCBA amendments).
- CBA's regulation on granting loans to banks (2016) and regulations on bank resolution (2018) cover bridge banks; determining actions for resolution of insolvent banks and holding auctions; and substantiation and comparative analysis of costs for selecting resolution measures. Notwithstanding this progress, the current safety net framework still has some limitations and the authorities are working to resolve them.

2. **Amending the LB and LDI would ensure compliance with FSB Key Attributes and IADI Core Principles for effective deposit insurance schemes, respectively.**

- ***LB:*** These would include: (i) extending the scope of the resolution framework to include bank holding companies and significant non-regulated operational entities within the group; (ii) including resolution objectives; (iii) including forward-looking resolution triggers and introducing governance trigger; (iv) state explicitly that CBA is empowered to apply resolution powers immediately on banks deemed non-viable or likely non-viable, based upon available prevailing information, and to start resolution preparation in the run-up to resolution; (v) empowering CBA to use its resolution powers without a requirement for court approval; (vi) empowering CBA/temporary administrator to raise capital for banks in resolution by issuing new shares; (vii) enhancing the bridge bank tool with sufficient safeguards; (viii) empowering the CBA—subject to necessary safeguards and restrictions—to impose a moratorium without any court approval; (ix) sufficiently reflecting the "no creditor worse off than in liquidation" (NCWL) principle; (x) including—in the resolution regime—liquidation options that provide for orderly closure or wind down of all or parts of a bank in a manner that protects insured depositors; (xi) making explicit that temporary public ownership should be an exceptional mechanism as last resort for the overarching objective of maintaining financial stability.

- ***LDI:*** These would include: (i) Absolving the requirement for coordination with the President to enhance ADIF's operational efficiency, response time, and independence; (ii) empowering ADIF to conduct on-site examinations to ascertain the integrity of deposits and depositors' data; (iii) giving ADIF the paybox-plus mandate; (iii) enabling ADIF to first and foremost increase industry contributions—including via extraordinary premiums—rather than borrowing from the CBA or Government when there is a probability that funds will run low; (iv) making borrowing from the CBA under government indemnity a source of emergency funding for ADIF; (v) empowering the MOF to provide ADIF a clear back-up emergency funding in cases where resources are insufficient to cover its responsibilities.